ELEMENTARY BANKING

BY

JOTI SWARUP, M.A.

Professor of Economics
Head of the Departments of Economics and Commerce
Vice-Principal, N.R.E.C. College
Khurja

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WITH A

FOREWORD

BY

DR. P. J. THOMAS
Head of the Department of Economics
University of Madras

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FOREWORD

ECONOMICS is largely the science of values and value is measured in money. Therefore Currency and Banking form an important part of an economics course. But the subject is difficult, and carefully written text-books on the subject are a long-felt need. The volume before us is one such text-book. It is a lucid exposition of the principles and policies underlying Indian Banking and Currency. It also deals briefly with the general problems of the subject and is thus a comprehensive text-book.

In recent years, Banking has made rapid strides in India, and the investment habit is steadily growing all over the country. At a time like this, there is need for popularising knowledge on the principles of this difficult subject. In fact, the elements of banking and currency ought to form an essential part of popular education to-day. In view of such requirements, Mr. Joti Swarup must be congratulated on producing a clear and concise account of banking and currency for the Indian reader. The book deserves to be read widely not only by the college students but by the public. It may also be useful if the book is translated into the principal languages of the country.

P. J. THOMAS.

UNIVERSITY OF MADRAS,
April 27, 1938.

PREFACE

THE addition of this book to the large stock of books on Banking and Currency needs no apology. This book has been written to meet the long-standing need for a suitable text-book on banking for students of Intermediate Commerce Classes in these provinces, in Rajputana and elsewhere. There are a number of books on banking and currency both for the general reader and the student, but most of them are advanced books on the subject and those which are not advanced are not suitable as text-books for Intermediate boys. I felt practical difficulty in teaching the subject to Intermediate classes. Either the students had to depend upon notes or had to fish out material for study from a number of books on the subject. Most of them often choosing the path of least resistance, their studies lacked definiteness and precision. Hence the introduction of this book. I lay no claims to originality; the book in fact is a compilation of material taken from a number of books on banking and currency and from blue-books and reports. The arrangement and presentation are mine and here and there I am responsible for a few opinions also. But my chief aim in writing the book has been to cover the syllabus and to make its language and thought suitable to beginners in the subject, and my task will be amply repaid if it is found to be a suitable text-book by those for whom it is meant.

In making the book I have purposely avoided too many details and too many facts and figures for my experience is that too many of these usually confuse a beginner and make the study of the subject uninteresting and dull. As the name suggests the book is an exposition of elementary principles of banking and currency and imparts elementary knowledge in Indian banking and currency. Though primarily meant for Intermediate students it can prove useful for B.A. and B.COM. students also.

I am sincerely thankful to Dr. P. J. Thomas, Head of the Department of Economics, Madras University, who took the trouble of going through the book and gave a Foreword to it. My thanks are also due to Prof. Krishna Kumar Sharma of S. D. College, Cawnpore, who went through the MSS. and made valuable suggestions for improvement. And in the end I must thank the publishers, The Bangalore Printing and Publishing Co., Ltd., Bangalore, not only for their promptness and excellent printing but also for their gentlemanly and courteous dealings.

JOTI SWARUP.

KHURJA,
25th August, 1939.

PREFACE TO THE SECOND EDITION

In the new edition which is going to the Press I have added two Chapters, one on the Value of Money and the other on the Monetary Systems. I have also added a few pages at the end to bring the history of Indian Currency up to date. With these additions not only the entire syllabus for Banking in Intermediate Commerce Classes has been covered, but the book has also become more useful for B.A. and B. Com. classes.

Joti Swarup.

N. R. E. C. College,
Khurja,
8th December, 1949.

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CHAPTER I

CREDIT

Nature of Modern Commerce

MODERN commerce is essentially different from what it was in the past. Not only have its size, the area of its operation and its speed increased enormously, but its nature has also become different. Commerce has now become world-wide, the market for most commodities is now as wide as the whole world, and the bulk of the commodities entering commerce consist of articles of daily and popular consumption. The number of commercial transactions has multiplied itself a hundred, a thousandfold and even more, and so has their rapidity. To liquidate these transactions, some medium of exchange is needed. The quantity of money is not enough to liquidate even a very small part of them. It would be utterly impossible for commerce to be carried on on such a large scale with cash payments.

Necessitates Credit

The instrument, which has made modern commerce possible, as also the modern large-scale production with its necessary round-about process and division of labour, is called 'Credit'. And as Mr. Macleod has rightly said, "What the steam engine is in mechanism: what the differential calculus is in mathematics: that is credit in commerce."[1]

Credit

Credit in its literal sense means trust or confidence. Actually credit means the deferring of a payment; it means the power which one person has to induce another to put economic goods at his disposal for a time on promise of future payment. In popular language, therefore, the power is called his credit, which enters into economics when he actually purchases something with it. When such a sale on credit takes place there is created a contract or obligation between the buyer and the seller. This contract or obligation consists of two parts: the right to demand payment, in the person of the seller (who is the creditor) and the duty to pay, in the person of the buyer (who is the debtor). The right to demand in the person of the creditor is termed 'credit', while the duty to pay, in the person of the debtor is the 'debt'.

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[1] *Theory and Practice of Banking*, Part I, Macleod, p. 187.

Credit manifests itself in credit transaction, which is a kind of exchange, and is a present transfer of economic goods or services in consideration of a promise of a future return of equivalent value. We know that commodities in the ordinary course of business pass through various hands. They pass from the manufacturer to the foreign importer, from the foreign importer to the wholesale dealer, from the wholesale dealer to the retailer, and from the retailer to the ultimate consumer. We have for the sake of illustration taken only a few intermediary agencies; in actual practice there are many more. However, even these few will serve our present purpose. If all these transactions were based on a cash basis, and all the receivers of goods paid the price immediately on receiving them, every one of these agencies should possess very large quantities of ready money. But this is not the case. Few persons have always ready money at command for what they require. And if all of them have not always got an adequate amount of ready money at command, they will have to stop or suspend their operations till they are able to get money from the ultimate consumer. It will mean that the stream of production and circulation would be vastly diminished and would not be continuous.

Credit and Larger Production and Continuity of Production

Now instead of cash payments, if there could be arranged a system of deferred payments between the various parties, we will see that production will not diminish, but will continue at the same pace or even at an accelerated one. The manufacturer sells the goods to the importer and agrees not to demand the price till some time afterwards and takes instead a promise from the importer for the payment of the sum involved at a certain future date.

The same procedure is adopted between the wholesale dealer and the retailer. The promises of the various purchasers have gone to liquidate the various transactions, just as money would have done it. There may appear to be one difference, however, between the two, namely, that whereas the receipt of money would have enabled the seller, to replace his capital, that of a mere promise may put him out of pocket for the amount upto the time that the promise is redeemed or honoured. But the seller will not be out of pocket if he could use the buyer's promise to get goods, which he wants and thus replace his capital. In actual practice this is possible. The seller in this case may buy the goods he wants, from another seller and instead of giving him money or his own promise, may endorse and hand him over the promise which he holds. The other seller will readily accept this promise as it is a double promise ; that of the seller and the buyer who originally gave the promise. The other seller who now possesses the promise may similarly endorse it and hand it over to some one else in consideration of goods, and so on, till the time of the maturity of the promise, when the ultimate holder of the promise will directly present it to the original promisor and receive payment. Thus we see that one promise has not only liquidated one transaction but has liquidated many ; and the stream of production has neither been diminished nor suspended.

We saw the work done by the promise of the importer: the promises of the wholesale dealers, retailers, and others will work in a similar way. Or we may take another instance ; suppose there are two merchants, merchant A and merchant B. A purchases goods worth, say Rs. 100, from B and gives a promise to pay this amount after a month. B purchases goods of an equal value from another merchant C and hands him over the promise of A. Now suppose C purchases goods worth Rs. 100 from A and hands him over the promise received from B ; but since the promise was originally A's and has ultimately been received by A, it automatically cancels, after liquidating three separate sets of transactions and without the use of any money at all.

Credit and Capital

Till now we have considered cases where exchange of commodities was effected by the creation and sale of credit, which was afterwards sold or exchanged for another credit. Such credit will, therefore, be limited by operations which have been made by commercial transactions. But credit, like money, can be applied to bring new products into existence. We may take an example to illustrate this. Suppose a Municipality wants to construct a building or a market-place, but has no ready money to buy the materials. The Municipality may issue bonds to the public, and thus borrow money on these bonds[2] repayable at a future date. The market-place or building can now be built, and will be real capital, as it would produce profit when given on rent. And as rents are received the bonds might be redeemed and the debt cleared off. Credit has been able here to bring into existence a new product. Credit, in fact being purchasing power, may be used to purchase labour as well as commodities. And it is clear, therefore, that money and credit have exactly the same effects on the production and marketing of commodities.

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[2] It may be observed that these bonds are the creation of property ; they are the right to demand a future payment, and can be bought and sold like anything else.

In actual practice the transactions between trades and traders are numerous, and all the transactions are not for an equal amount, nor are all the traders known to one another. There arises, therefore, the necessity of institutions that must be widely known and trusted and whose business may be to purchase the credits or debts of various merchants or to manufacture credit on the basis of the various commercial transactions. Such institutions are the Banks, and we will see later how they perform these various functions.

The system of credit has, therefore, been divided into two branches: Commercial Credit and Banking Credit. With the first the merchants buy commodities and it is payable at a certain time after date.

The second is where bankers buy these commercial debts or credits, by creating credits of their own which are payable on demand. Commercial Credit terminates at a future time at which it is created terminable. Bank Credit, which must be payable on demand, is not intended to be terminated or extinguished, but is created with the hope that it will continue in existence and work like money. Besides these there are other classes of credit also, as Public Credit, Capital or Industrial Credit and Individual or Personal Credit. Public Credit means the borrowing operations of governments by means of interest-bearing securities. Capital or Industrial Credit refers to the borrowing of necessary finance by industrial corporations for their business operations. Individual or Personal Credit refers to the obtaining of individuals of consumption goods without paying cash for them.

In the various transactions noted above we have seen that where cash payment is not made on spot, a credit or a debt is created. This credit, we have seen, purchases goods and services just as money does or, in other words, it can be purchased for another credit, or, which will be the same, can be exchanged among themselves.

Credit Instruments

But credit, in order that it may be capable of actual delivery, must be recorded on a material. When it is recorded on paper, the latter is called an instrument of credit. There are various kinds of credit instruments and we shall now proceed to examine their forms and kinds.

Their Forms

Instruments of credit are created in two forms, or in other words, a credit or a debt can be recorded in two ways. They may be in the form of an order from the creditor to the debtor for payment, or in the form of a a promise of the debtor to pay his creditor or any one else he may name.

Just as the system of credit has been divided into two branches—Commercial Credit and Banking Credit—so are the credit instruments divided. Commercial Credit gives rise to Commercial Credit Instruments, like the Bill of Exchange and the Promissory Note ; while Banking Credit gives rise to Banking Credit Instruments such as the Bank Notes, Cheques, Letters of Credit, etc. We have already explained the difference between commercial credit and banking credit. The difference between commercial credit instruments and banking credit instruments lies in their range of negotiability or acceptability. Banking credit instruments are more widely and readily accepted than those issued by private individuals. The reason is obvious. The bank is a more widely known and trusted institution ; its credit instruments, therefore, have a wider acceptability.

Bills of Exchange

A Bill of Exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or the bearer. This is the legal definition of a Bill of Exchange. The usual form of a Bill of Exchange is as follows :—

FORM OF A BILL OF EXCHANGE

15 Annas *Calcutta*, June 18, 1930.

Three months after date pay to Mr. Ram Prasad or order the sum of one thousand rupees, value received.

To SHIV LAL.

MR. DEVI RAM,
10, Hornby Road, Bombay.

It will be clear from the definition that a Bill of Exchange is an order from the creditor to the debtor for payment. There are three parties to a Bill—the drawer, the drawee and the payee. It is the business of the payee, on the first convenient opportunity, to get it accepted by the drawee, who, if he agrees to pay the amount, will write "accepted" across the bill.

The payee may keep the bill with himself till it matures, or he may transfer it to some one else, by endorsing it. The endorsee may again endorse it and thus the bill may pass into several hands. The bill can thus be transferred from hand to hand and the property in the bill is also thereby transferred.

The above bill, we find, has arisen out of a commercial transaction. Devi Ram has purchased goods worth Rs. 1,000 from Shiv Lal, and wants to pay the price after three months, when he thinks he would sell off the goods, realise their price and obtain ready money. Shiv Lal, on the other hand, has to pay Rs. 1,000 to Ram Prasad. Shiv Lal has drawn this bill or order on Devi Ram to pay Rs. 1,000 to Ram Prasad after three months. Ram Prasad, to be sure that he will get the money after three months, asked Devi Ram to accept the bill, who writes "accepted" across the bill. Now Ram Prasad has three courses open; either he can retain the bill till it matures and then demand payment from Devi Ram or he may endorse it to some one else from whom he purchases goods, or may sell the bill to a Bank. The advantage of the last two courses is that Ram Prasad will be able to renew his capital or recover the use of his capital before the three months expire. Now at the time of the maturity of the bill, any person who is the rightful owner of the bill can demand payment from the acceptor, who cannot deny the debt, and in the event of a default, the transaction which gave rise to the bill will not be considered, but the bill itself will be a *prima facie* evidence of the existence of the debt.

Thus we see that Bills of Exchange are very useful credit instruments, which obviate the necessity of the employment of large sums of money. They are very good media for the settlement of national and international indebtedness and reduce, to the minimum, unnecessary movement of specie, and the risk of expense involved therein. They offer a very easy means of recovering the use of capital and they consolidate debts and facilitate recovery in the event of default.

The Bill of Exchange besides being a remarkably simple and efficacious device for financing commerce, is also an ideal form of investment for bankers and others who are obliged by the nature of their business to keep their resources liquid. A Bill of Exchange is easily negotiable before maturity and on maturity is cashed by the sale of goods on which it is based ; it is therefore an ideal thing to invest money in. But this can only be said of genuine bills, *i.e.*, bills which arise out of genuine trade transaction and not of accommodation or finance bills.

There are Bills of Exchange known by the name of Accommodation Bills, Finance Bills and House Bills, which are not really speaking genuine bills, though in outward appearance there is no difference between them and genuine bills, and it is well nigh impossible to distinguish the one type from the other. Accommodation Bills are those which do not represent an actual exchange of values and are drawn by a person and accepted by the other without consideration, merely to enable the drawer to raise money on the bill. Finance Bills are those which are created not on the basis of real produce in existence, but in anticipation of that produce. Such bills, as has been shown in another chapter, are quite legitimate and are highly useful. But the creation of such bills has been carried further, and bills are created for the mere purpose of discounting them ; such bills are created against property that would be difficult of realisation. House Bills are those bills which are drawn by a firm or a company on its own branch or office at another place.

Such bills which are not genuine, and consequently do not pay themselves automatically (just as genuine bills do at maturity owing to the sale of the value on which they are based) do not possess the merits of a good credit instrument, but introduce danger into the extension of credit. In the words of Withers, "The importance of the bill of exchange thus lies in a merit and a danger attached to it. The merit is the fact that in its genuine form it facilitates trade by creating credits and so supplying cash against real produce not yet marketed and is also an ideal form of investment for those whose investments must be liquid, or certain of easy realisation. The danger is the ease with which it can be created against securities which may not be readily marketable, or by being drawn on firms by themselves, or by correspondents, in order to provide cash for speculative enterprise."[3]

Promissory Notes

A promissory note is an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand, or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer.

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[3] *The Meaning of Money*, Withers, p. 55.

FORM OF A PROMISSORY NOTE

Calcutta, June 18, 1930.

Rs. 1,000/-

---

15 Annas.

Three months after date I promise to pay Mr. Shiv Lal or order the sum of one thousand rupees.

DEVI RAM.

In our previous transaction there could be two ways for the acknowledgment of the debt by Devi Ram. He could either accept the order of Shiv Lal for payment, or give his own promise to Shiv Lal for the payment of the amount of debt. Here we find that Devi Ram gives his own promise, and therefore the credit document which is brought into being is a Promissory Note and not a Bill of Exchange. In the sphere of its usefulness and in its working the Promissory Note is not different from a Bill of Exchange. It is as good a Credit Instrument as a Bill of Exchange, and can be transferred and sold just like a Bill of Exchange. There is one essential difference, however, between the two. In the case of a Bill of Exchonge, if the acceptor turns to be a defaulter, money can be recovered from the drawer or the drawee, but in the case of a Promissory Note it can only be recovered from the promisor.

Bank Notes

Bank Notes are promissory notes, issued by a banker, binding himself to pay the sum named therein to the bearer immediately on demand. Bank Notes are transferable by mere delivery, and the owner or holder can claim their amount from the bank at any time within reasonable hours. Bank Notes being payable on demand bear no interest, they are never bought at a discount and are issued in convenient denominations. They are thus exactly like currency notes and circulate like them.

The banks issue notes either against coins and bullion or against bills which they purchase. In the first instance if the amount of notes issued is the same as the amount of bullion kept, they are merely certificates of deposits and do the same amount of work as bullion or coins would have done, except that they are more convenient to handle and easy to carry. When they are paid for bills purchased, the transaction amounts to the exchange of the banker's credit for that of the parties of the bill. Since the banker's credit is more widely acceptable, notes serve a wider field than the bill would have done.

Since the bank is a well-known institution in which people have confidence and trust, and since notes are convenient media of exchange and can circulate like money, a large part of them is not presented to the bank for redemption. The bank knows this, and it therefore issues notes much beyond the amount of coins or bullion that it keeps for their redemption. Thus here we see that notes instead of representing a certain amount of cash, are really instruments of credit, and do a much greater amount of work than the cash kept by the bank could have done. The banks thus could go on increasing the note issue thereby increasing the supply of credit. The temptation to increase the note-issue (it being profitable to the bank) being very great, there is always the danger of the banks issuing notes beyond the safety limit. To guard against this danger most of the Governments have placed restrictions on the issue of notes by banks; and at the present day in almost all countries, it is only the Central Banks which are allowed to issue notes and that too under restrictions.

But so far as notes are issued within proper limits, they form an excellent instrument of credit, much easier to handle and carry and they increase the country's working capital to a great extent.

Cheques

A cheque is an uncondiional order drawn upon a banker, directing him to pay on demand, a certain sum of money to, or to the order of, a certain person or to the bearer. The following is the form which a cheque usually takes :—

FORM OF A CHEQUE

No. 67321 *19th June* 1930. In favour of Mr. Ram Saran Das Rs. 5,000. RAM KRISHNA.	No. 67321 *The 19th June* 1930. IMPERIAL BANK OF INDIA (Cawnpore Branch) Pay to Mr. Ram Saran Das or order Rs. Five Thousand only. Rs. 5000-0-0. RAM KRISHNA.

It is clear from the definition that the cheque is an order on a bank, and is payable on demand, *i.e.*, the bank has to pay the money immediately on the presentation of a cheque. But why does the bank pay cheques drawn upon it? It does so because either somebody has kept some money with the bank for safe custody or the bank has allowed a loan. In both cases the bank gives the right to its customer to draw upon it to the extent of the deposit or the loan.

Customers of the bank, who either keep their money with the bank or who take loans from the bank, find it more convenient and safe to keep the money with the bank and to draw upon it by means of cheques whenever they need it. The cheque is a more convenient and safer medium of making payment than cash, and besides this it is useful in other ways also.

Cheques provide an easy and cheap means of remitting money from place to place. A cheque (preferably a crossed or an order cheque) for quite a big amount can safely be sent from one place to another in an ordinary cover affixed with an anna stamp. To send an equal amount of cash would be much more costly and risky.

To make payment through a cheque is safer and more secure because when a cheque is drawn in favour of somebody, there is a record made on the counterfoil, which remains with the drawer ; and when the cheque is paid by the bank, a record of payment is made in the books of the bank and usually the signatures of the payee are taken on the back of the cheque.

The cheque also serves as an evidence in the case of disputed payments, as these are made through a bank. It is easier to draw a cheque than to count and pay cash, when payment of large sums is involved. The use of cheques, as we shall see later, facilitates settlement of mutual claims and this avoids the exchange of money.

We have seen that cheques arise out of deposits. These deposits, whether created out of actual money deposited with the bank, out of loans granted by it or out of bills purchased by it are in the nature of credit transactions. Or in other words when the bank does any of the above things it created credit, or rights of action against itself, which in banking language are called deposits ; and the cheques which are drawn upon these deposits are the instruments of this credit.

Suppose that a deposit is created by a bank on receipt of Rs. 10,000 cash from a customer X. The customer X has the right to draw cheques on the bank to the extent of the deposit. If X were to draw a cheque for the whole amount, say in favour of A, and A would have immediately demanded cash from the bank, the deposit could not be called credit. But if A (being the customer of the same bank) instead of demanding payment would have sent the cheque to be deposited in his account there would be no necessity of payment, but the bank would make two entries in its books: it will debit X with Rs. 10,000 and credit with the same amount. This shows that though the transaction between X and A has been liquidated, no cash has been used to do it; it was only the bank's credit which liquidated the transaction.

We may further suppose that in the above case A instead of immediately sending the cheque for being deposited, endorses it in favour of Y and Y does so in favour of Z and Z deposits it in his own account with the bank. In this case we find that one cheque has liquidated three transactions as between X and A, A and Y and Y and Z and no cash has moved in any direction.

Here we have supposed that there is only one bank, and all the above persons are customers of the same bank. In reality there are many banks, and different persons are customers of different banks. But this should create no difficulty, for bankers have so arranged among themselves that cheques drawn upon the one and deposited with the other and *vice versa* are cancelled through the banker's clearing house and only the balance due from one bank to the other is paid—and that too may be paid by means of cheques drawn upon the central bank with which all banks keep their accounts. Thus transactions to the extent of millions of rupees may be liquidated by means of the banker's credit, without involving the use of an equal amount of cash.

The knowledge that all the money deposited with it is not demanded at the same time induces the bank to employ a large part of the money deposited with it in granting loans or purchasing bills and thereby creating more deposits. We may take an illustration. Suppose a customer has deposited Rs. 10,000 with a bank. The bank Balance Sheet will stand as follows:—

Liabilities	*Assets*
Deposits Rs. 10,000	Cash Rs. 10,000

Knowing that all the cash will not be demanded at one time, or whatever demand is made it is more than offset by new deposits, the bank may utilise Rs. 10,000 cash for creating more deposits. It leaves, say, Rs. 1,000 for meeting the above deposit and with the rest Rs. 9,000 it buys bills, but not bills to the value of Rs. 9,000 only, but, say, to Rs. 40,000 for even for bills purchased it does not pay cash, but only credits the seller of the bills with their value and gives him the right to draw upon it. And knowing that the right to draw is partially exercised and cheques are cancelled through the clearing house, it can safely buy to such an extent. Now after purchasing the bills the accounts of the bank will stand thus :—

Liabilities		*Assets*	
Deposits	Rs. 50,000	Cash	Rs. 10,000
		Bills	Rs. 40,000
	Rs. 50,000		Rs. 50,000

So that we find that the bank with only Rs. 10,000 cash has created deposits or credit to the extent of Rs. 50,000.

When, therefore, a banker has created a credit or deposit in favour of a customer, he can put this credit into circulation by means of a cheque ; and the customers might utilise these deposits in three ways :—

1. They might demand payment in cash, in which case the banker's liability will extinguish.

2. The cheque may circulate in commerce and effect any number of payments, exactly like money, and the cheque may ultimately be paid into the account of another customer of the same bank, and the series of transactions may finally be closed by the mere transfer of credit from one account to another.

3. The cheque after circulating in commerce may be paid into another bank, and through the mechanism of the clearing system may be cancelled. Here again there may be only a transfer of credit, for by the "ingenious arrangement of the clearing house, the use of coin and bank notes is entirely dispensed with : and all the banks in the clearing house are really and practically formed into one huge banking institution for the purpose of transferring credits among each other, just as credits are usually transferred from one account to another in the same bank without a single coin being required".[4]

The deposit credit and its instrument, the cheque, do an enormous volume of money's work. The volume of business which is carried through under such a system is colossal. Through payment in cash it would have been utterly impossible to carry on such a turnover. There is not enough currency in the commercially developed countries to pay for their single day's commercial transactions; and even if the money were there, it would take an army of men to count and pay it ; while a cheque for the biggest amount can be drawn in no time. In the words of

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[4] *Theory and Practice of Banking*, Part I, Macleod, p. 332.

Prof. Taussig, "Deposits in their operation as a circulating medium are among the most marvellous of economic phenomena ... In countries where deposit banking is largely resorted to, like England and the United States, all wholesale transactions and a large and growing volume of retail transactions are carried only by them. They combine in a remarkable degree safety and convenience. They are safe because a cheque is payable to a specified person, and the bank is answerable for making payment to that person only or to his endorsee. They are convenient because a few strokes of the pen serve to remit any sum, however large, and to remit that sum precisely to the last cent. The mechanism is wonderfully smooth and effective."[5]

A cheque payable to bearer is an order addressed to a banker, requiring him to pay the sum named to the bearer of the cheque on demand. It bears no interest, and can be transferred from hand to hand without formality. In all these, except for the fact that it can be drawn even for an odd sum, a cheque is like a bank note and should circulate like it. But it is not so ; the field of the acceptability and the scope of circulation are narrower in the case of cheques than in the case of bank notes. Cheques are instruments of limited acceptability. The limitations of the cheque are due to the uncertainty as to the account or balance of the depositor. Payments in cheques are accepted, only from those who are well known, and in whom the receiver of the cheque has full confidence.

The length of time for which cheques circulate is also limited. The law provides that if the holder of a cheque does not present it in 'reasonable time' he loses his claim against the drawer, if the bank on which the cheque is drawn happens to fail. Hence cheques are presented, at an early date of receipt, and come to serve as mere instruments of transfer of money, and involve no considerable length of credit. And though they are presented early, cheques are not generally cashed, but are deposited with the same or with some other bank, for money with the bank is safer and sometimes interest-bearing.

Bank Drafts

Bank Drafts are bills of exchange drawn by one bank upon another or upon its branch or correspondent, directing it or him to pay a certain sum of money to or to the order of a specified person generally on demand. They are either drawn against cash deposit with the bank, or, in the case of customers, against their accounts. Such drafts are paid on demand and need no acceptance.

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[5] *Principles of Economics*, **Vol. I, Taussig, p. 337.**

FORM OF AN INLAND BANK DRAFT

ALLAHABAD BANK, LTD.

No. 2/15 *Delhi*, 25*th October* 1935.

On demand pay to Mr. S. L. Mital, the sum of Rupees One Hundred only.

To

T. LEWIS, ESQ.,
Allahabad Bank, Ltd.,
Lucknow.

For the Allahabad Bank, Ltd.,
W. JONES, *Agent.*
R. BIHARI, *Accountant.*

FORM OF A FOREIGN BANK DRAFT

No. 3/37

CHARTERED BANK OF INDIA, AUSTRALIA AND CHINA

Exchange for £1,000 *Delhi*, 1*st October* 1935.

On demand pay this Second of Exchange (first being unpaid) to the order of Mr. R. S. Sharma, the sum of One Thousand Pounds sterling, value received.

For the Chartered Bank of India, Australia and China,

To

C. W. THOMAS, ESQ., *Agent*,
Chartered Bank of India,
Australia and China,
6104 |44, Beaver Street, London.

A. ALFRED, *Agent.*
C. BROWN,
Sub-Accountant.

Bank drafts are generally obtained by those who want to remit money from one place to another, as remittance through drafts is conducted by banks on the principle of the postal money order system. Actually cash is not transmitted, but only entries are made in the books of the bank on the one hand and its branch or another bank on the other. Besides inland payment, foreign payments are also often made by purchasing bank drafts at the current rate of exchange.

We have already seen that a bank when it receives money from its customer gives him in exchange its own credit. This credit or debt is expressed either in the form of an entry in its books called deposit or the bank may give him a written document in various forms, such as a bank note, circular letter, letter of credit, etc., thus a draft is a credit instrument which represents a debt or credit. It may be negotiated and utilised for liquidating commercial transactions, but it is usually used for transmitting money from one place to another.

Cash Credits

The system of granting cash credits is very popular in Scotland, which was invented there, and to which the marvellous progress and prosperity of that country is mainly due. Cash credits are created when the banks agree, on receiving sufficient guarantee, to open or create credits to a certain amount in favour of respectable and trustworthy persons. "A cash credit is, therefore, simply a drawing account, created in favour of a customer, upon which he may operate in precisely the same manner as on a common drawing account. The only difference being that instead of receiving interest upon the daily balance to his credit, as is very commonly the custom in Scotland, he pays interest on the daily balance at his debt. It is thus an inverse drawing account."[6] All these cash credits are made exclusively in the bank's own notes.

Every man in business needs some cash to meet day-to-day requirements and for other petty expenses. Thus every business man must keep some cash at his command, which he cannot employ in business. Money at hand is idle money and does not earn anything. But if somebody else for a small charge could be ready to supply the business man cash, whenever he needed it, the business man would feel no necessity of keeping cash with himself, but could employ it more profitably in his business. When the bank creates cash credit in favour of a business man, it enables him to invest the whole of his capital in trade, and thus aids in a better and a fuller utilisation of capital.

In Scotland this system of cash credits has developed very much ; and cash credits are available to all, poor or rich, to youngmen commencing business or to established business men, industrialists or agriculturists. Most youngmen commencing business in Scotland do it by means of cash credits. And the chief stimulus to the development and progress of agriculture in Scotland has been in instruments of cash credits. Everything depends upon character. Youngmen in the humblest walk of life inspire their friends with confidence in their steadiness and judgment, and they become sureties for them for a cash credit. This is exactly the same thing as money to them and they have the means placed within their reach of rising to any extent to which their abilities and industry permit them. Multitudes of men who have raised themselves to enormous wealth, began life with nothing but cash credit."[7]

The banks usually limit their advances to a certain moderate amount, varying from £100 to £1,000, and take several sureties, never less than two. Enormous amount of transactions is effected on the basis of cash credits. It is said that on a credit of £1,000 operations to the extent of £50,000 take place in a single week.

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[6] *The Elements of Banking*, Macleod, p. 159.

[7] *Ibid.*, p. 160.

Certificates of Deposits

Certificates of Deposits are virtually receipts given by a banker to the depositor for the money deposited by him with the banker. A person may deposit a sum of money in a bank merely for safe keeping or for the use of another person and receive a certificate. But a certificate of deposit does not only certify that the sum has been deposited, it also guarantees that it is payable to the order of the depositor himself or that of another person whom he may designate as payee. The sum deposited will be paid to the holder on return of the certificate. No interest is allowed on such deposits if they are to be paid on demand, but where sums are deposited for a certain time interest may be allowed.

Certificates of deposits are mostly used to make transfers of money to a distant place, but they are used for other purposes also. A person starting on a journey may obtain a certificate of deposit, or more than one, for use in raising funds on his way. Funds can be raised from the bank's correspondents and branches and also from other banks, for such certificates are readily honoured. Such certificates can be endorsed and transferred; and besides being used for the transfer of money from place to place they are also, though only to a small extent, used for liquidating commercial transactions. "They stand for deposits of actual money which can be diverted to no use but their redemption on return to the bank that has received the funds, though the right to payment may be transferred on the way and applied to credits between banks. They may also be deposited and make their way through collections and clearings."[8]

Letters of Credit

A Letter of Credit is a written request addressed by one person to another requesting the latter to give credit to the person named therein. Usually it is a document issued by a banker addressed to a banker abroad, requesting him to pay the bills of the bearer to a certain amount mentioned in the letter of credit.

Besides foreign letters of credit mentioned above domestic letters of credit are also issued by banks, and are used similarly by persons travelling over long distances in their country and are also used for commercial purposes.

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[8] *The Modern Bank*, Fiske, p. 161.

A man who goes to several cities to make purchases or payments may obtain letters of credit upon which he may raise money for his purposes at convenient points on his way.

Letters of credit take various forms ; in general they are printed documents issued by bankers and accepting houses authorising the persons to whom they are issued to draw bills upon them within prescribed limits and undertaking to accept and pay the bills so drawn.

The importance of this system in foreign trade is very great. When goods are imported from abroad an immediate payment in cash is not made, but instead, the exporter is allowed to draw a bill upon the importer for the value of the goods. This bill the exporter usually discounts with a bank or sends it with the documents of title to a bank in the importer's country with instructions to deliver the documents when the bill is accepted, or both accepted and paid as the case may be. Now in many cases the bill drawn on the importer (not being well known) may not be discounted by a bank, or even the exporter himself may not like to send goods on the mere security of bill drawn upon him. In such cases a letter of credit granted by a bank to the importer, undertaking to accept and pay bills drawn upon it makes the importing on goods possible. A bill drawn by the importer upon the bank will readily be taken by the exporter as a security for goods he will send or the exporter will be ready to send goods on the security of the bill drawn upon the bank. The bank which issues such a letter of credit accepts the bill drawn upon it and will pay it when presented by the holder ; though, of course, for this purpose it is put in funds by the importer in good time before the acceptance arrives at maturity.

The above credit allowed by the bank to the importer may be an 'unconfirmed credit' or a 'confirmed credit'. Unconfirmed credit is one in which the bank reserves to itself the right to cancel the credit later on if it likes to do so. A confirmed credit, on the other hand, cannot be cancelled; once the letter reaches the guarantee the credit is irrevocable and for this reason a foreign exporter who has no knowledge of the condition and means of the importer in another country can safely send his goods and be reasonably sure that his bill will be met at maturity.

The bank which grants such credit or thus accommodates the importer, does so either on the security of the document of title, surrendered to it, or if it knows the importer well, on his personal security. Where the party accommodated enjoys a first class reputation financially the business between him and the accommodator may be conducted solely on the strength of that reputation, and the credit is then known as 'Bank Credit'.

When, on the other hand, the accommodator stipulates additional security of the documents covering the shipment in respect of which the bills are drawn, the credit is known as 'Documentary Credit'.

Circular Letters and Circular Notes

A Circular Letter of Credit is a letter addressed by a banker to his foreign agents or correspondents authorising them to pay the person specified in the letter such sums as may be required up to a stated aggregate and to recoup themselves by drawing at sight or otherwise upon the issuing banker. Circular letters of credit are in fact often issued to firms who wish to send representatives abroad and to whom it is desirable to draw amounts upto a certain specified sum at places visited by them. Generally speaking, these are very economic credits as they do not cause firms to tie up an amount of money for a long period of time.

Circular Notes are practically credits issued by banks on their own special forms. They are generally issued for the convenience of travellers, who want facilities to draw money from the Bank's agents or correspondents in foreign towns. They are usually issued for round sums (as say Rs. 50) and are accompanied with a letter of indication which bears the signatures of the customer and of the bank, and is a request to the various correspondents to cash the notes on presentation, after obtaining signature of the customer on the back of the notes, and comparing it with the one on the letter of indication.

CHAPTER II

BANKING

Early Banking

IT has been maintained that banking is a very old institution; we will see later that banking business was carried on in India in very ancient times. It has an equally ancient origin in Europe. The Romans are said to have been familiar with cheques and bills of exchange—the necessary appendage of banking—and carried on the business of banking. Though we do not doubt the existence of banking in ancient times, yet we maintain that banking, in the form in which it exists to-day, is of recent origin. In other words, we may say that with the growth and development of other social and economic institutions, the institution of banking has also grown and developed and has become so elaborate that it has acquired the form which has not much in common with its ancient form.

The gigantic form which commerce and industry have acquired is comparatively of recent origin. Before long, when means of communication were not developed and methods of production were simple and crude, society was at best in the self-sufficing stage. Things were produced on a very small scale for local or self consumption. In such a condition the need for capital was small, and whatever capital was needed, could be supplied by the producer himself. Private capital other than that which consisted of the ownership of land, buildings and slaves was not of great volume.

Later on, when commerce grew and also industry, there arose the necessity for more capital and for credit. But still the chief capital employed in large-scale industry in early stages was the slave; while merchants had large capital in the form of goods, ships and beasts of burden. The early phases of business credit were that the traders were the chief capitalists and the sovereigns and governments were the chief borrowers.

At one time merchants were the chief dealers in credit, and they not only supplied credit and capital to commerce but also to industry. The work of manufacture was carried on in their homes by craftsmen, who were supplied with material, tools and funds by merchants. Industry was thus dependent on trade, and the merchants were its chief bankers.

There were professional money-lenders too in those times, but their business of financing industry had not developed and that of financing commerce had developed only to a small extent. The work of credit then was different. A great part of it was given to spendthrift heirs, and to others who were hardpressed for money. Credit was hardly employed for productive purposes.

Change in the Nature of Banking

But the relation of banking to industry changed gradually. Handicrafts gave place to factory production, and the manufacturer became powerful and rich. When factory production had been well set up, it ceased to be dependent on trade for its supply of capital. It began to borrow from the general public. With the growth in manufactures trade also developed. Goods began to be sent for sale to longer distances and in greater quantities.

With the advent of the Industrial Revolution and with the development in the means of communication, production assumed entirely a new form. It began to be localised and carried on on a larger scale. Modern production is characterised by division of labour. With division of labour comes specialisation, and these two intensify mutual dependence. Goods are now produced for a wide market; and for most of the durable goods the market is as wide as the world itself. Large-scale production involves the lengthening of the period of production and a round-about process of production—first the production of capital goods and then of directly consumable commodities. The possibility of indirect or round-about process of production depends upon the existence of what we call capital.

Capital and its Creation

For the creation of capital the first necessary condition is saving; but it does not only mean mere saving, it involves as well the creation of capital goods, which may be serviceable for further wealth production. The actual process of the creation of capital in modern society is obscured by the use of money. From beginning to end the notion of money permeates our economic thinking and not without reason, for the prevailing economic system would be impossible without it. The money saved has to be applied to productive uses. But all those who save are not capitalistic producers. In order that the savings of the multitude may be useful, they should be available to those who will employ them in the further production of wealth. In theory it may be possible that those who have saved may directly lend the use of their savings to those who want them for further wealth production, but in practice it is well nigh impossible. Those who save are innumerable and scattered and their individual savings are small. Moreover the man who has saved, will not lend his savings unless he is sure of their safe return ; and unless he finds it worth his while to lend them. To bring those who save in direct contact with producers is extremely difficult. There is needed some agency, the business of which would be to collect the savings and to advance them to those who need them for productive purposes. Such an agency is the 'Bank'; and one of the important services that a bank renders to society is this—it mobilises investment funds, and assists in the apportionment of the funds for productive uses.

Supply of Working Capital

Due to the introduction of division of labour and the roundabout process of production, the time involved in production became long. The producer could get his finished product only after a certain time. During this long period he needs what is called working capital ; and unless the working capital were forthcoming this lengthy system of production could not be possible. The modern bank here again comes to the rescue ; it supplies the working capital.

On account of large-scale production, localisation of industries and a world-wide market, the goods produced could not directly and immediately be supplied by the producers to the consumers. Goods before they could be available to the ultimate consumers had to pass through many hands ; those of the middlemen in commerce and transport, who made it possible that goods produced in one corner of the world could be available for consumption in another. The producer as soon as he parts with his finished products wants their price ; the ultimate consumer gets these only after sometime and he pays for them only when he actually receives them. During this period the various processes of handling the goods have to be financed : working capital is needed by the various middlemen in commerce and transport. This again is supplied by the bank, without whose aid it could not be available and a world-wide commerce could not be possible.

Supply of Media of Exchange

We have already noted that with the growth in industry, commerce also grew. When production began to be carried on on a large scale, the goods produced became cheaper, the luxuries of the past became necessaries of the subsequent period. Commerce also assumed a different form, on account of the development in the means of communications; not only did it become world-wide, but it also very much swelled in size. Sale and purchase transactions grew in number and became more rapid. Trade grew to such a size and became so rapid that the amount of the medium of exchange (money) available, could not suffice to liquidate even a part of these transactions. There arose, therefore, the necessity of creating a device through which a small available amount of money could do the work of much more. This device the banks created by creating credit.

Transmission of Money

The growth in the size of trade and its national and international character involve the transmission of money from one place to another in a country, and from one country to another. The transmission of money from one place to another involves great expense and risk. The bank has obviated this risk and expense, by the device of the cancellation of debts.

Services of a Bank

The above are some of the very important economic services that the modern bank is rendering to society. As Mr. Agger says,[1] banking stimulates saving, economises the use of capital set aside for the purpose of facilitating the rapid utilisation of available capital implements, releases to the capable *entrepreneur* capital not otherwise available. By these and other services banks not only promote the most economical use of capital but they also afford a stimulus to the whole productive process and enlarge the opportunity of individuals with capacity, assuring to society at the same time a fuller utilisation of that capacity. Indeed, it might almost be said that modern large-scale production, with its necessary roundabout process, with its sale of goods on credit, and with its large dealings would be practically impossible without banks. "The Bank is the most important instrumentality in the modern system of industry and trade. Without it this system could never have developed, and without it, it could not now be maintained ... It has been the chief motive power in the advance of material civilization in the last century and it has been made possible by the device of banking, which is based upon trust and confidence among men and has consequently been a potent agency in stimulating and strengthening integrity in commercial dealings."[2]

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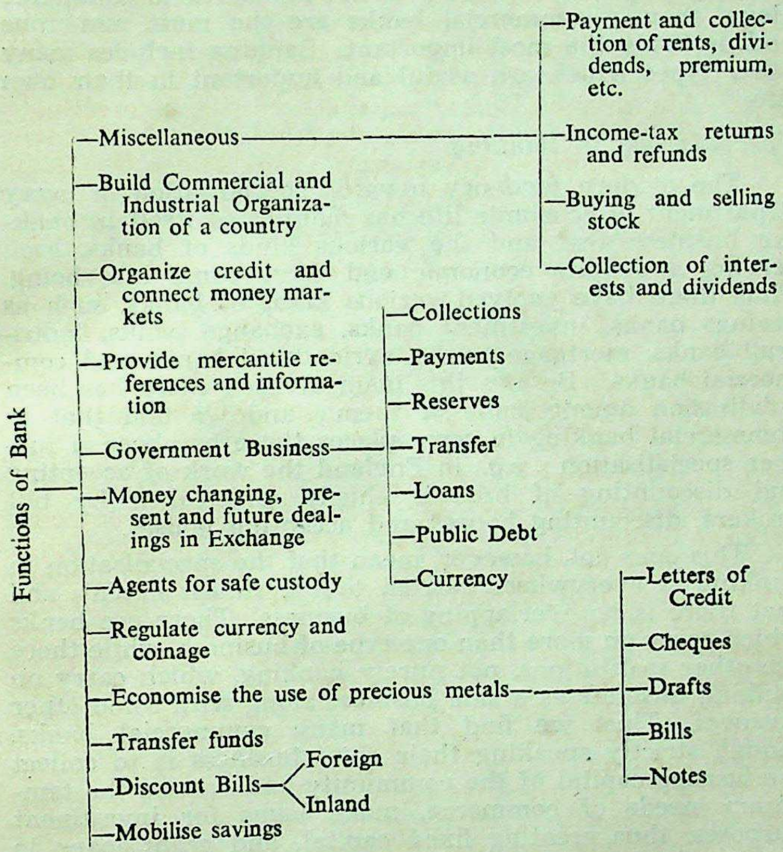
[1] *Organized Banking,* Agger.

[2] *The Modern Bank,* Fiske.

The modern banks perform many functions. The following chart will give an idea of how many and varied the functions are :—


Functions of Bank
—Miscellaneous
—Payment and collection of rents, dividends, premium, etc.
—Income-tax returns and refunds
—Buying and selling stock
—Collection of interests and dividends
—Build Commercial and Industrial Organization of a country
—Organize credit and connect money markets
—Provide mercantile references and information
—Government Business
—Collections
—Payments
—Reserves
—Transfer
—Loans
—Public Debt
—Currency
—Money changing, present and future dealings in Exchange
—Agents for safe custody
—Regulate currency and coinage
—Economise the use of precious metals
—Letters of Credit
—Cheques
—Drafts
—Bills
—Notes
—Transfer funds
—Discount Bills
Foreign
Inland
—Mobilise savings

Its Responsibility

We have seen how important a position the bank occupies in the economic world of to-day. But if its importance is great its responsibility is greater. Through the decisions that it makes in extending credit it controls to a great extent the flow of the community's capital. Its ability to understand and to measure human nature may mean the fulfilment or the destruction of the hopes of the individual; and upon its keen insight and judgment may hang the prosperity of the whole community. If it shoulders the responsibility well that rests upon it, it deserves a high reward, but if it is negligent and irresponsible it can do enormous mischief.

CHAPTER III

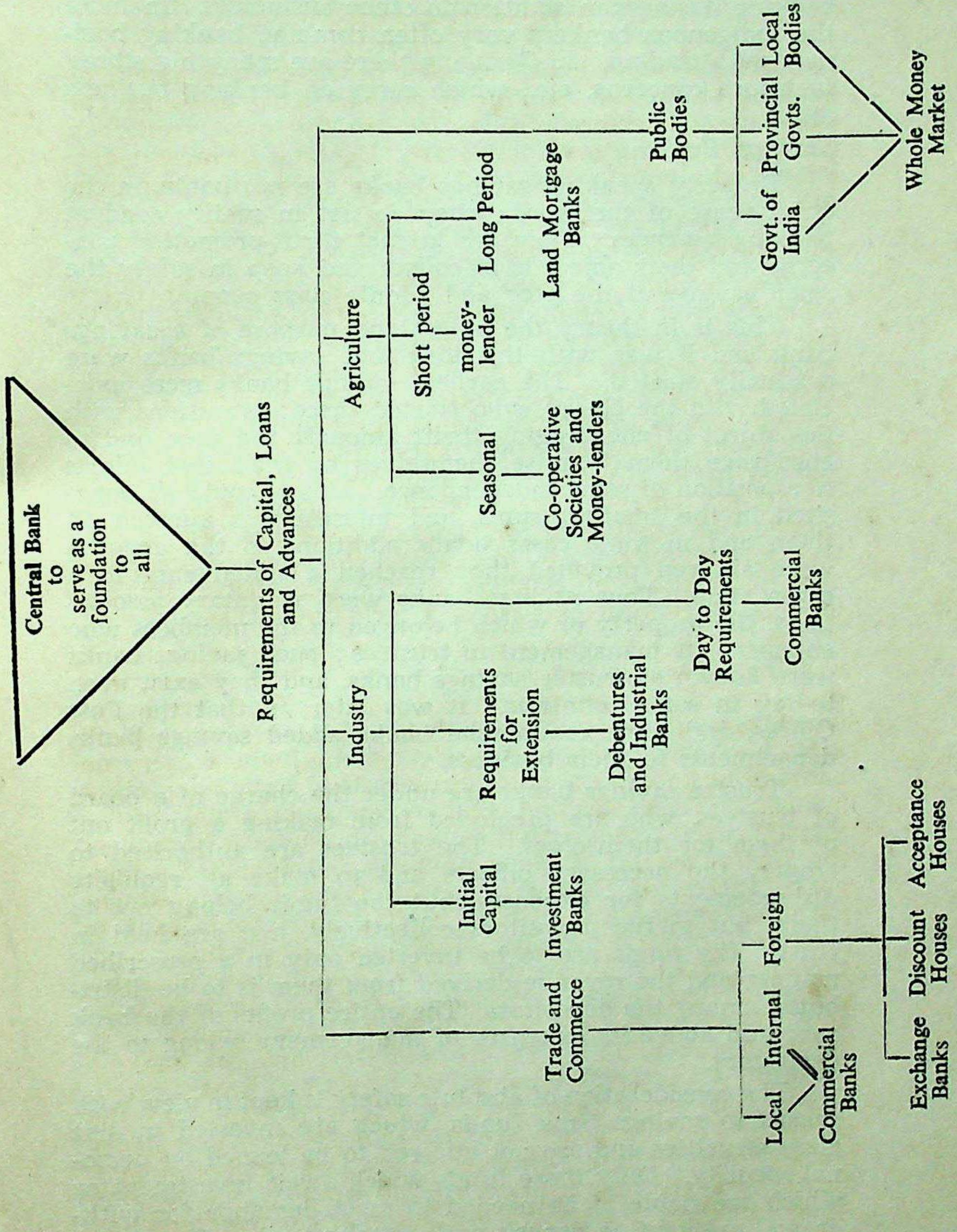
KINDS OF BANKS

USUALLY the word bank has been restricted to commercial banking only. But banking is not restricted to commerce alone, though commercial banks are the most numerous and probably the most important. Banking includes many other types which are useful and important in their own life.

Specialisation in Banking

The modern tendency towards specialisation in every department of economic life has manifested itself in banking business also, and the various kinds of banks, each serving a definite economic end, have come into being. Thus there have evolved various kinds of banks, such as savings banks, investment banks, exchange banks, industrial banks, mortgage banks, agricultural banks and commercial banks. Besides this main division there has been subdivision among some of them ; and we find that in commercial banking in some places there has been a further specialisation ; *e.g.*, in England the work of accepting and discounting of bills is chiefly undertaken by bill brokers, discounting houses and accepting houses.

This does not, however, mean that the specialisation in banking is everywhere carried to the fullest extent, and that there is no overlapping of business. There are banks which carry on more than one type of business, while there are other institutions, not purely banking, which carry on banking business as a side business along with some other business. Thus we find that many commercial banks, though strictly speaking their chief business is to collect the floating capital of the community and finance the temporary needs of commerce, make loans for investment purposes, thus creating fixed capital, and grant loans to persons for purely consumptive purposes ; while many exchange banks besides their own legitimate business, finance commerce and carry on commerecial banking business. Most of the commercial banks have savings bank departments ; while in France and Germany the banking institutions are partly commercial banks and partly syndicating and promoting concerns. German banks in the words of Lord Inchcape are "Clearing Banks, acceptance houses, issuing houses, discount companies, promoting syndicates, traders and bankers". The same is the case in America ; there is a general confusion of commercial banking and investment banking there, and recently the loan and trust companies have taken up banking business. Again in many countries, the private bankers carry on


Central Bank to serve as a foundation to all
Requirements of Capital, Loans and Advances
Trade and Commerce
Industry
Agriculture
Public Bodies
Local
Internal
Foreign
Commercial Banks
Exchange Banks
Discount Houses
Acceptance Houses
Initial Capital
Investment Banks
Requirements for Extension
Debentures and Industrial Banks
Day to Day Requirements
Commercial Banks
Seasonal
Co-operative Societies and Money-lenders
Short period
money-lender
Long Period
Land Mortgage Banks
Govt. of India
Provincial Govts.
Local Bodies
Whole Money Market

banking business in addition to other businesses. In India the indigenous bankers very often combine banking business with trading. In Germany there are many big stores, furniture concerns, etc., which carry on banking business also.

Savings Banks

Properly speaking savings banks are not banks in the strict sense of the word ; they do not in reality conduct banking business. They are in fact thrift-promoting concerns and their object is to collect and keep in safety the small savings of the poor and middle class people.

This is in theory the object and purpose of a savings bank and it was with this idea that savings banks were originally started. The earliest savings banks were associated with the clergy, who started these institutions with the object of encouraging thrift amongst the poor and to encourage them to raise themselves by their own efforts to a position of some independence. Money could be deposited in the smallest sums, and interest was allowed on them and in some cases bonus additions to the deposits were allowed provided they reached a stated sum in a given time. Thus savings banks were voluntary associations, the property of which belonged to the members who entrusted its management to trustees ; such savings banks were known as trustee savings banks, and they exist even to-day in some countries. It was later on that the Post Offices, and some commercial banks added savings banks departments to their business.

Trustee savings banks are under the charge of a board of trustees, who are precluded from making a profit out of them for themselves. The trustees are authorised to employ the necessary officers and to make all requisite disbursements for expenses, but the funds belong not to them, but to the depositors collectively, and are held in trust. The funds are to be invested only in a prescribed manner and the revenue derived from them is to be distributed among the depositors. The entire profits of the bank over and above its expenses of management belong to the depositors.

The consideration of absolute safety is kept in view with regard to savings bank funds, which are invested in first class securities and are not allowed to be loaned on personal security. Only those funds which await investment or which are liable to be needed to meet demands for withdrawal are kept on deposit with regular banks. The choice of savings banks in making loans is almost in every country limited by law to the safest and the best securities ; and as the amount of deposits always exceeds possible withdrawals, they do not maintain handsome reserves.

It is the function of savings banks to mobilise funds not immediately needed but required to be kept in a semi-liquid form. The savings bank depositor does not want his deposits to be payable on demand, he is generally in a position to give notice of his intention to withdraw the whole or part of his deposit. Owing to this character of the savings banks, funds to a great extent are normally not drawn upon in a progressive community. With some savings banks, enjoying the confidence of the community, current withdrawals are more than offset by new deposits, hence the savings banks can afford to invest a large proportion of their funds. Though their investments must be made with an eye to the possible and probable withdrawals, safety and security are of greater importance in this field than is immediate redeemability. The borrowers from savings banks are generally those who need capital for definite investment purposes.

The character of the savings banks thus is that of the middle-man, but not of that middle-man whose work is finished when he has brought contracting parties together. The savings bank is always obliged to repay the savings entrusted to it at least after receiving due notice. It must therefore be responsible to the depositor for the manner in which his funds are employed by it.

Rules relating to making deposits and their withdrawal differ in different countries ; but usually everybody can deposit his money in savings bank, and is given a pass book in which the amount deposited is credited. Each time when the depositor either wants to deposit money or withdraw it, he has to present his pass book at the bank for the entries to that effect. It should be noted, however, that the balance is always a credit balance in the pass book, and there can be no overdraft to produce a debit balance, which could be made in no other way. Withdrawals are generally allowed to be made once a week, and notice in some cases is needed for withdrawing money beyond a certain amount. As has already been said the procedure adopted in different countries is different. As regards procedure adopted in India, it has been given in another chapter on Indian savings banks.[1]

There are various kinds of savings banks in the United States of America. In England the trustee savings banks still exist, though they have been overshadowed, long ago, by the Post Office Savings Banks. In India the Post Offices manage the Government Savings Banks, and the commercial banks also have savings banks departments.

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[1] Indian Savings Banks Chapter.

Investment Banks or Trust and Finance Companies

The business of investment banks is to mobilise investment funds and to assist in the apportionment of these funds among productive uses. The investment banker is a middle-man pure and simple. Those who have new enterprises to finance come to him for aid, and he, in the main, raises the necessary capital by creating an interest among his clients for the enterprise ; sometimes to meet temporary needs he may make some advances from his own funds too.

As we shall see later the nature of commercial banking does not permit commercial banks to invest their funds in fixed assets, *e.g.*, buildings, lands and machinery, etc.; in the interest of safety their funds must remain in a comparatively liquid form, that is to say, must be invested in assets which are quickly realisable in cash. They can thus finance commerce alone ; industries and other enterprises, which need financing for longer periods must seek aid elsewhere. The agency which finances the latter is that of the investment banks, who have chosen the special task of aggregating funds and lending them for long-term purposes. They have, therefore, large paid-up capital of their own and attract long-dated deposits, both of which can be locked up in assets which are more lucrative but less easily realisable than commercial paper. They generally issue to the public debentures payable after ten, twenty or more years, and invest their resources in various industrial concerns, such as railways and other enterprises.

Besides doing constructive work of floating, aiding and financing joint-stock companies, investment banks also undertake 'salvage' work. They purchase the assets of companies which have failed and try to improve the condition of those concerns which may be under difficulties.

Such investment companies and finance houses are mainly investment bankers ; they also engage extensively in foreign exchange operations, and are mainly to be found in England. In Germany and France where there is not much specialisation in the field of banking (except land credit and co-operative credit) investment banking is mostly in the hands of larger commercial banks.

In the United States of America there are numerous Trust Companies, which are a class of corporation which do more or less banking business. On the banking side the business of the trust companies is conducted in much the same way as of a commercial bank. They receive deposits from regular customers but such deposits are fewer in number and larger in individual amounts and are for longer periods. They allow interest on deposits above a certain limit. They loan their funds on time and on a variety of securities, on demand as well as on call loans. Since they do not come under the definition of ordinary banks they are free from any absolute requirement of cash reserves, and have a wider range of investment and the use of their funds. This gives them an advantage over other banks, but at the same time they are more open to the temptation of hazardous employment of their resources. In practice, however, they have for the most part been conservatively and safely managed; those which have been less cautious have come to grief, but their failures are not likely to cause so much injury as would come from bank failures.

Exchange Banks

As the name itself indicates Exchange Banks are those which finance the exchange business or the foreign trade of a country. Their sole concern is generally to undertake only foreign exchange business. As exchange business is attendant with great risks, these banks have to depend to a large extent on their own capital, and cannot, consistently with safety, open themselves to demand or short notice obligations. The financing of foreign exchange business is intricate and, therefore, expert and skilful handling of it is necessary. When operations are conducted successfully the profits are large and exchange business has proved to be quite a profitable one to the banks.

The exchange banks finance foreign trade by purchasing bills from exporters and selling them to importers, by exporting or importing precious metals and securities, by drawing and selling their own drafts on foreign countries and by undertaking "forward operations".

It will be clear from the chapter on foreign exchange, that for most of the exports the exporters draw bills on the importers in foreign countries for payment on the bill's maturity. The exporter or the drawer of the bill, instead of waiting till the maturity of the bill, generally discounts it with or sells it to the exchange banks, whose business is to purchase such bills. Now the exchange banks who have purchased these exporters' bills may either keep them till maturity or may sell them before it to the importers of their own country who have debts to pay to the foreign exporters, or they may deposit them with their banking correspondents in other financial centres. The exchange banks use these bills in any of the above three ways, as they find it profitable at the time. Some of the bills they keep with them till maturity, some they sell to the importers and the rest they deposit with their foreign correspondents.

These banks draw their own drafts on the deposits created with their foreign correspondents. And whenever anyone is in need of sending money abroad, he may purchase an exchange bank's own draft and send it to his creditor in the foreign country, who can get it cashed at the exchange bank's foreign correspondent's office. For this purpose these banks have to maintain balances abroad, which they sell for more than it has cost them to accumulate them there. But they have to replenish these balances as soon as they drop to a certain minimum.

Exchange banks liquidate international indebtedness by exporting or importing precious metals and securities also.

Whenever there are either not enough bills to offer or drafts to issue payments abroad are made by sending precious metals, and the exchange banks undertake this business of sending them on behalf of their clients. This business gives the exchange banks the scope to handle gold and silver bullion, and they are as well dealers in gold and silver.

Lastly the exchange banks sell 'forward exchange', and through these 'forward' operations of exchange they render two distinct services to the community—of reducing the unnecessary oscillations in the exchange value of their country's currency, and of protecting the merchants or industrialists who purchase forward exchange against any loss which might occur in their legitimate profits on account of exchange oscillations. By means of 'forward exchange' a merchant who has a payment to make in or receive from a foreign centre at the end of a certain time may settle now with the bank the rate of exchange for the future payment of the future receipt and so may know immediately the exact amount he must pay or receive and be free from future concern about fluctuations in the rate of exchange. While the risk of loss to the merchant on account of changes in the rate of exchange is mitigated, the exchange bank which undertakes these risks also protects itself by setting off one operation against the other. It covers itself by setting off a sale by a purchase and *vice versa*, *i.e.*, when it has sold a forward exchange it also purchases one to an equal amount, or when it has purchased a forward exchange it sells one to an equal amount; thus any loss on the one operation is cancelled by an equal gain on the other.

As has already been said above, exchange banking is rather risky because of fluctuations in the rate of exchange and has to be carried on with skill and should not be combined with commercial banking. The business has, however, become safer with the introduction of the exchange standard system. Prior to its introduction the exchange rates between gold-using and silver-using countries fluctuated widely and the exchange relations between such countries were of a speculative character. With the adoption of the exchange standard by the silver-using countries, the speculative element has to a great extent been reduced.

In England, America and the Continent besides the exchange banks, the commercial banks also deal in foreign exchange business. In India the business is carried on purely by the exchange banks, which are foreign banks, and which conduct ordinary banking also in addition to the financing of the foreign trade of the country.

Industrial Banks

Industrial banks are those banks, which finance and aid the industries of a country. Industries, however, do not include agricultural industries, for agricultural finance is essentially different from industrial finance, and to finance agriculture there generally exist the agricultural banks. The duty of the industrial banks is to help the *entrepreneur*, by supplying him the necessary capital, required for the purpose of production, on the strength of industrial security. The commercial banks cannot advance money on these securities for two reasons ; firstly, because the securities are not of a sufficiently liquid character and are not quickly realisable and the loans needed are for a long time, and secondly, because the commercial banks have not the proper means and are not well equipped to understand industrial problems and to judge and decide between the claims of really sound and honest industrial ventures on the one hand and bogus enterprises on the other.

The institutions which can properly finance industries, therefore, are the industrial banks, which usually have a high paid-up capital and take in deposits for fixed periods of long duration and have industrial experts to advise them on the soundness or otherwise of the industrial ventures requiring financial help and the extent to which loans should safely be granted to different clients.

The industrial banks, not only direct and control the flow of the community's capital, thereby assuring society the fuller and proper utilisation of it, but also exercise an effective control over many of the industrial concerns financed by them by having their representatives included in the directorate of those companies, and in general, lend a healthy tone to the entire industrial system of the country by refusing to help those concerns which are not sound and honest or are not properly managed and conducted.

The first thing that an industrial bank does, when a corporation approaches it for giving marketability to its issue of securities, or for direct financial aid or when an *entrepreneur* who has launched upon a new industrial venture wants initial capital, is to fully investigate into and analyse the securities, the business of the corporation or the proposed scheme. So far as securities are concerned the bank will ascertain whether the proposed issue is sound and has sufficient merit to be offered to a conservative public. Being satisfied of its soundness it proceeds to fix a selling price which will be satisfactory to the corporation and at the same time enable the bank to make a profit on the transaction.

Such banks have nothing to do with speculative securities; they handle only the best kind of securities and thus aim at establishing a reputation for conservatism. While offering the securities to the public they look to the safety of the principal, and the certainty of interest or dividend. For this reason they make a most careful examination of the issuing corporation's condition and the character and ability of its management and avail themselves of all possible information. The price of the securities is fixed according to the results of the examination and the general condition of the money market at the time.

When a new concern is started or a new industrial scheme is taken up by an existing corporation, it issues shares or debentures or stock to the public for supplying the necessary initial capital. The investment public is generally very conservative and may not be willing to subscribe to the capital of an unknown concern; or even if it may be willing to subscribe, the whole amount of the share capital offered for subscription or the minimum subscription as fixed in the memorandum of association may not be taken up by it in the prescribed time. In such cases the industrial bank comes to the rescue and makes possible the launching of a new scheme by "underwriting" the share capital or stock. Underwriting has been defined as "An agreement entered into before the shares are brought before the public, that in the event of the public not taking up the whole of them or the number mentioned in the agreement, the underwriter will for an agreed commission, take an allotment of such part of the shares as the public has not applied for". The function of underwriting is thus to assume the risk that is incidental to the raising of funds required and assure the corporation that it shall have its funds on a specified date whether or not the securities have been sold to the investing public. "In the absence of this medium (underwriting) many an enterprise that would have flourished and, perhaps, altered the country's economic position to its advantage, would fail for want of public support towards the subscription of its capital, through unreasonable doubts or unusual pessimism on the part of the investing public."[2]

When the bank has underwritten the capital of the corporation, it becomes its business to sell it to the public. The corporation has nothing to do with it now and is freed from a task for which it was at best ill-fitted, and can, instead, devote itself to its more legitimate business. The bank which, on account of its reputation and equipment, is better able to undertake such work, sells the securities quite easily and with less expense too.

In cases where direct aid is needed by industrial concerns, the industrial banks provide that also, either by lending money for long periods or by themselves contributing to the share capital or debenture issue of the concerns. Here also the banks are very particular in first fully investigating, through their expert staff, into the working of the corporation or into the possibilities and prospects of a new scheme. In case the bank is fully satisfied it may advance the necessary help after it has acquired a controlling hand in the future conduct of the business by having its representatives included in the directorate.

Besides the above, industrial banks render certain other allied services to their customers including both the investing public and the borrowing corporations. They sell to their clients safe securities yielding satisfactory returns. The industrial banks often become advisors to their customers and assist them in selecting the best type of securities. To this end they furnish reports and general information to corporations; they recommend favourable periods and the best types of securities to issue.

The place of industrial banks in the general economic organization of a country is very important. Industrial banks, wherever they exist, assist to a great extent in directing the distribution of industrial energy. They play a dominant role in directing the flow of capital and labour as between different industries and between different departments in any given industry. Those ventures which fail to receive the support of the industrial banks, may never come to fruition, and rightly too, if the banks are performing their task honestly and efficiently.

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[2] *Business Organization, Davar,* p. 154.

Industrial banking lessens the cost of producing goods, by taking up the task of selling shares, underwriting them, giving marketability to them and by otherwise advancing financial aid to industries. It frees the industrialist from a very difficult task, namely, that of raising the funds required for his operations. Most industrial concerns and corporations are, however, poorly equipped for the marketing of securities and the cost involved in their case would be much greater than to a regularly organized industrial bank. The industrial banker, on account of his being a specialist in the trade, has the advantage of having a great deal of skill in advertising and salesmanship of shares and stock; and can do much of his advertising of any particular issue along with other issues, and thus can divide the expenses involved. He makes it possible for a corporation to enter into contracts and to proceed with its business in the light of definite knowledge, both as to the amount of the funds that would be received and the time at which they will be received.

Industrial banks are financing educators and render a great social service in educating the general public along financial lines. By means of conversation with their clients, by issuing general advertisement literature and by publishing folders and circulars which discuss investment principles, they, from the standpoint of economic development, go a long way to teach the advantages and necessity of thrift.

The industrial development of a country possessing potential resources is to a large extent dependent upon the availability of industrial energy. The economic history of countries like Germany, the U.S.A. and Japan amply shows that the presence of industrial banks in these places has been the chief, if not the sole, cause of their industrial development. India, which has great natural resources for her industrial development is lagging behind, chiefly on account of the lack of industrial capital. The necessity of organized industrial banking is very great in her case. The present state of industrial banking in India is very bad, and any improvement and development in that line will be a real and essential step forward in the economic development of the country.[3]

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[3] For Industrial Banking in India consult the chapter on Indian Industrial Banks.

Agricultural Banks

We have already mentioned above that agricultural finance is different from other kinds of finance, and is, therefore, dealt with by special institutions meant for this purpose. The problem of agricultural credit resolves itself into two sections : Long-term credit and short-term credit. Long-term credit is needed for introducing permanent improvements in land, buying more land and introducing better methods and costlier implements. Short-term credit is meant to supply working capital to the agriculturist for buying seeds and manure, for personal and labour expenses and for paying water rates and taxes, etc.

Just as commerce and industry and international trade need capital and credit for their conduct and development, so does agriculture. But the length of time for which agriculture needs these and the securities that it can offer are of a different nature, and that is the reason why commercial banks or industrial banks or exchange banks are not in a position to take up agricultural finance.

Taking long-term credit first we find that money for capital improvements can be repaid only slowly and gradually from annual savings and the security which can be offered is that of mortgages of property of the borrower. The institutions equipped to advance loans on these terms are known as Mortgage Banks, which render two distinct services, that of financing permanent improvements in agriculture and of creating safe and sound means of investment for the investor who wants to invest his money for a long time.

Such a bank has a large paid-up capital of its own and obtains money in the following way :—Its capital is, in the first instance, utilised in taking some mortgages. On the security of these mortgages it issues bonds to the public and gets money, with which it takes more mortgages. The second batch of mortgages is similarly assigned for a second lot of bonds and the same procedure is repeated over and over again.

Loans are advanced only for productive purposes. The property is strictly valued and advances are made upto 50 to 60 per cent. of the value. Repayment is made by fixed annual instalments spread over the period of the loan and a reasonable rate of interest is charged.

The security of bonds being safe and stable, they are always in great demand. Trust funds are sanctioned to be invested in them and insurance companies find it safe to keep their funds in them. Owing to there being always a ready market for them and their prices being comparatively stable, they can be resold at any time without any loss.

Thus mortgage banks create negotiable bonds of real estate, without the creation of which, transferability in land and real property and the floating of loans on their security will be a very lengthy and cumbersome process. Houses and lands are not easily transferable as it involves the compliance of many formalities imposed by the Civil Law. Mortgage banks make this easier "by creating blocks of securities out of real estate and making them available in the market for investment".

The business of mortgage banks is quite safe and there should be no reason for the failure of such banks if a sound evaluation of land and due limitation of loans to half the appraised value of the land is strictly followed.

Mortgage banks are doing successful business in Germany, France, Spain, Austria, Hungary and Japan. The Credit Foncier of France, the mother of all mortgage banks, the German Hypotheken-banken, the Mortgage Bank of Spain, the Mortgage Bank of Austria-Hungary are all thriving institutions. The Agricultural Mortgage Corporation started recently has been doing well in England. In India, the supply of long-term credit for agricultural purposes is almost non-existent. In a country, which is predominantly agricultural and the agriculture of which is most backward, the need for mortgage banks for permanent improvements in agriculture is very great.

If in long-term credit the borrower has the security of his land to offer, the borrower of short-term credit, the agriculturist, has practically no security to offer except that of his plough, oxen or a small hut, and at the same time, wants credit in small amounts. No concern (except the village money-lender) started with the object of earning profits could find it worth its while to supply finance on these terms.

The money-lender who takes upon him the risk of advancing loans to the ryot, charges a very high rate of interest, rather a usurious rate, and does not make it his business to know as to whether the loan taken is used for productive purposes or otherwise. His only concern is to exploit the agriculturists according to the urgency of their needs. Wherever, therefore, the regime of the rural money-lender has remained uncombated the condition of the cultivator is anything but desirable.

As we have already said above the task of supplying credit to the small and scattered agriculturists is not lucrative and entails a great deal of difficulty; it cannot be taken up by organizations run for the sake of profits. Advancement of credit requires both security and knowledge of the borrower's character and habits. An outside organization can neither be sure of the repayment of the debt nor can have adequate means to know the borrower well. Therefore in this field only those institutions which are run on co-operative lines by the villagers themselves have been found to be the sole means to meet the problem. Germany was the pioneer in this line, and was the first to start what are known as "Village Co-operative Credit Societies". Other agricultural countries followed suit and similar societies more or less on similar lines are now found in all of them.

Co-operative Credit Societies

The agriculturists of a village or more join together, contribute their own capital, and advance loans amongst themselves. "Pooling their joint resources and on the strength of unlimited personal liability they borrow loans in the money market which they distribute to the members for productive purposes at a low rate of interest. Loans are usually repaid by monthly instalments and are secured by promissory notes of members with two or more endorsements of co-members for character and not collateral is the basis of their loans."[4]

The share contributed by each member is fixed and accordingly the credit of each member is also fixed. The profits which may accrue to the society are distributed among its members.

Besides meeting the need for short-term agricultural finance, co-operative credit societies are very useful institutions in educating the generally illiterate and conservative agriculturist in many useful things. On account of their co-operative nature they develop among the members the idea of self-help and mutual relationship, promote thrift, encourage industry and train members in the art of self-government.

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[4] *Elementary Banking*, Rau, p. 14.

CHAPTER IV

COMMERCIAL BANKS

BY the word bank we generally mean a commercial bank. Whenever any other kind of bank is meant the qualifying epithet is used before the word bank, such as industrial bank, investment bank, or agricultural bank. Commercial banks are so numerous and common that most people when they hear the word bank think of a commercial bank.

Its Functions

While considering the functions and working of other kinds of banks, we saw that the business of all of them was to aid in mobilising the savings of the community and to make them available for productive purposes. The commercial bank has this as its main service. But it is not a middleman pure and simple; it is, besides, a highly creative and dynamic agency that goes farther in its control of capital than the money actually entrusted to it would indicate. Through the creation of credit payable on demand it mobilises and applies to production that portion of the wealth of the community which is in a relatively liquid form, and which must be preserved in that form. Its supreme function is to manufacture an inexpensive medium of exchange, thereby economising the use of metallic money, and rendering modern large-scale production and world-wide commerce possible.

A bank ordinarily is considered to be a place which has strong rooms and strong boxes for safely keeping the money of other people ; and on this idea a banker was defined as a man who took care of other people's money. This is however, a very incomplete definition of a bank. The bank may be defined as an institution which deals in money and credit and which manufactures credit.

The following are the principal functions of a commercial bank :—

(1) To receive deposits of money ;
(2) to discount bills of exchange and promissory notes;
(3) to grant loans ;
(4) to act as agent for customers for the collection of dividends, bills, cheques, etc., and for the payment of annuities, subscriptions, premiums, etc.;
(5) to act as warehouseman for customers and take charge for safe custody the valuables and deeds and documents of its customers ; and
(6) to transfer money from one place to another.

Sometime back the issue of notes was a very important function of commercial banks. But in most countries it is now restricted to the central banks, which are distinct institutions of their own kind. Note issue is thus no more the function of ordinary commercial banks, and is, therefore, not included here among their functions.

Deposits

1. The bank receives large sums of money either as current deposits or as fixed deposits. The customer who deposits money in current account can withdraw the whole or part of it whenever he may so desire. The withdrawal is made by means of cheques, which are payable on demand. Generally no interest is allowed on current deposits, and in some cases the customer is required to leave a minimum balance undrawn with the bank. The minimum balance differs with different banks. Some banks even allow a small rate of interest, as 2% or 2½% on current deposits.

When money is deposited as fixed deposit or in deposit account, it cannot be withdrawn before the expiry of the period for which it is deposited, or without giving a due notice of withdrawal. On deposit accounts the banks pay interest, which varies according to the market rate of interest, and the length of notice required for withdrawal.

Discount

2. When a bank discounts a bill or promissory note it buys a right due at a fixed future time, and gives in return an immediate right to demand money; and for this the bank makes a charge known as discount. Or in other words when it discounts a bill or note it pays a little less, as its present value, than its face value. The charge made includes the interest on the money for the tenure of the bill and an insurance against any risk involved. The person who has discounted his bill or note with the bank can either take the money immediately or can leave it with the bank in his current account and can withdraw it as and when he requires it. Usually money is left with the bank in current account.

Loans

3. Banks advance money on loan to their customers. Loans are advanced only to those in whose credit the bank has confidence, and who can deposit with the bank good and easily realisable securities. Commercial banks advance loans only for short periods, usually for three to six months, and only in a few cases for a year. The interest charged

on the loans varies according to the market rate of interest, the financial standing of the party, the security deposited by him, the length of time for which loan is advanced and the amount of loan.

The loans so obtained by the customers are usually not taken immediately but are left with the bank in their current accounts to be subsequently withdrawn as and when required.

Agents of Customers

4. Customers find it more convenient to collect their dividends, cheques or bills payable to them, or pay subscriptions, insurance premiums, bills, etc., through their banks. The bank renders them this service for a small charge, and for it the customers are saved of a lot of worry and inconvenience involved in collections, payments and in keeping accounts.

Custodian of Valuables

5. Banks also keep in their safe custody the valuables of their customers. The banks are safer and more secure places for keeping these than are the houses of the owners. Usually the banks make no charge for rendering this service to their customers, but some may.

Remittance

6. By means of their branch system and through relations with other banks, banks are in a position to transmit money from place to place cheaply and easily. The banks do so by means of cheques, bank drafts, credit notes, letters of credit, etc., and make only a nominal charge for this service. People who have to transmit money from one place to another find transference through the bank both cheaper and safer.

As we have seen earlier, banks do not actually send specie or coins but by means of book entries they cancel mutual indebtedness. Thus they obviate the movement of coin or specie and thereby save the community the cost and risk involved therein.

Assets and Liabilities

Before considering how a bank carries on its business in actual practice, it will be useful to first examine the various assets and liabilities of a bank. For this purpose we will draw out an imaginary balance sheet of a commercial bank and try to understand the various items enumerated therein.

LIABILITIES	ASSETS
1. Share Capital: (*a*) Authorised (*b*) Subscrisbed	1. Resreve: (*a*) Cash in Hand (*b*) Cash at Bank (*c*) Call Loans and Other Securities
2. Do. Paid-up	2. Bills Discounted
3. Reserve Fund	3. Loans and Advances
4. Deposits on Current Account	4. Bills Receivable (liability of customers for bank's acceptances)
5. Fixed Deposits	5. Bank Premises and Furniture, etct.
6. Bills Payable	
7. Bills Receivable as *per contra* (acceptances on behalf of customers)	
8. Profit and Loss Account	

Capital

On the liability side the first item is authorised and subscribed capital. Authorised Capital indicates the amount upto which the bank can issue its shares capital. It is not necessary that the whole of it may be issued at the start. Subscribed Capital is that capital which the shareholders of the bank have subscribed, but not necessarily paid, but for the payment of which they are liable whenever they are called upon to do so. The amount, which the shareholders have actually paid, constitutes the next item, *viz.*, the paid capital of the bank at the start.

Reserve Fund

The third item is the Reserve Fund, which is built up out of the accumulated profits of the bank, not distributed amongst the shareholders. It is the usual practice with most banks not to distribute the whole amount of the annual profits among the shareholders but to transfer a part of them to a fund called the reserve fund. The reserve fund thus accumulates from year to year and increases the working capital of the bank. The amount of the paid-up capital and the reserve fund are generally invested by banks in remunerative but less easily realisable assets. Since these form the bank's own capital, which unlike its other liabilities the bank is not liable to pay on demand or short notice, it can in order to earn higher profits afford to invest them in investments of a more fixed nature.

Deposits

Items four and five are the two deposits on current and deposit accounts. We have already seen what they mean. We may, however, note here that the liability of the banker on the current deposits is of a more stringent nature, it being obliged to pay them whenever demanded, it cannot utilise these to a great extent for earning profits; and this is the reason why it does not allow any interest upon them. Fixed Deposits on the other hand can only be demanded on the expiry of the period of deposit, and the banks can invest them or advance them as loans or utilise them in any way for such a period and earn profits on them. The banks, therefore, allow interest on fixed deposits.

Bills Payable

Bills Payable are those bills which the bank has drawn upon its branches or its agents in other places or other countries and has sold for cash to those people who wanted to remit money from one place to another. These bills will have to be paid by the bank when they are presented. And as such the liability for them is of the same nature as for fixed deposits. When a bank sells a bill and receives cash for it, it means receiving so much deposit to be paid back on the maturity of the bill.

Bills Receivable

The next item, Bills Receivable, as *per contra*, is a contingent liability. These are bills which the bank has accepted on behalf of its customers, binding itself to honour the bills when they are presented, in the expectation that it will recover the amount from the customers on whom they are drawn. So that these bills are shown both as an asset as well as a liability. As an asset because the drawee has to pay their money to the bank, and as a liability because the bank is liable to pay them to the drawer or holder irrespective of the fact whether the drawee pays for them or not.

Balance

Item number eight represents the balance of assets over liabilities, or in other words it shows the profit earned during the year *plus* the profit brought forward from the last year. From this dividends are distributed to the shareholders and a part of it is taken to the reserve fund.

The Reserve

Turning next to the assets side, the first item consists of the Reserve. This should, however, not be confused with the Reserve Fund on the liability side. These two are quite distinct. While the reserve fund represents the accumulated profits, the reserve is the actual cash or its equivalent that the bank keeps with itself. The reserve is divided into three parts :—(*a*) cash in hand, which includes gold and silver coins and notes, (*b*) cash at bank, which represents bank's money in deposit with the central bank, and is available on demand and is kept there for the convenience of clearing cheques, and (*c*) call loans and Government and other securities. Call Loans or loans at call and at short notice represent those loans of the bank, which it has advanced for very short periods and which are repayable either on demand or at a few hours' notice. Some of its money the bank has also invested in Government and some other first class securities, which have a steady market, and which can be sold at any time in the stock exchange market. The reserve is thus constituted of either actual cash or the equivalent of cash, *i.e.*, of such assets which can be turned into cash without any delay.

The reserve is meant to meet the bank's demand liabilities and other liabilities which may fall due on a particular day. The bank is bound to meet these liabilities and in order to be prepared to do so it keeps the reserve.

Bills Discounted

Item number two, Bills Discounted, represents those bills which have been purchased or discounted by the bank. Such bills are payable on maturity by their acceptors, from whom the bank will collect their amount in due course.

Loans and Advances

Loans and Advances represent the amount of loans which the bank has advanced to its various customers on the strength of security pledged or on customer's promissory notes or as a result of customer's overdraft. A customer whose credit is good, may be allowed by the bank, temporarily, to draw more money than what he actually has in his account or a customer who has both fixed and current deposits, may on the security of the fixed deposit be allowed an overdraft in his current account. The bank charges the usual rate of interest on such overdrafts.

Bills Receivable

Bills receivable represent those bills which the bank has accepted on behalf of its customers, on the understanding that their money will be paid to the bank before their maturity. They are thus both an asset and a liability and are shown on both the sides of the Balance Sheet.

Premises, etc.

Bank premises and furniture refer to the buildings and fixtures, etc., of the bank. The value of these is written down every year from a portion of the annual profits set apart to cover their depreciation.

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Business of a Commercial Bank

Commercial Banks, like any other commercial concern, aim at earning profit. They are not philanthropic institutions, but are profit-making concerns. They are started with the purpose of gain, and that purpose is always the foremost. We know that commerce means the exchange of commodities. This exchange has become so widespread and of such a magnitude that various middlemen or commercial concerns have come in to facilitate and aid exchange. In so doing they render a service, which is paid for by those to whom it is rendered. Or in popular language they buy commodities at a low price and sell them at a higher one. The difference is their profit.

So far the business of the commercial bank resembles that of commercial concerns: they buy money and credit (the commodities in which they deal) at a low price and sell them at a higher one; and the difference is their profit. But a commercial banker is not only a middleman, he is a manufacturer as well; he manufactures credit and money and sells same, and whatever he gets as their price also constitutes his profit. But as are the profits of the bank high, so are its liabilities or obligations great. It is obliged in every instance except in the case of deposit accounts to pay legal tender money on demand. In case it fails to do so it comes into liquidation and has to stop its business ultimately. It has thus to be very cautious in its business. It has always to be prepared to meet its demand obligations, and to meet other obligations when they fall due. To do this the bank must keep a very large amount of legal tender money at its command, which will mean that a very large portion of its funds will lie unemployed and its profits will, therefore, be curtailed to a very great extent. But it is not so; experience has shown that the whole of these demands, or even a majority of them, are not made at the same time. Bankers know this, and on this assumption, on which rests the modern banking system, they carry on their business.

But this assumption holds good for normal times and normal conditions. There may be times, when on account of some political or other reason, the demands may suddenly be unusually large; or even in normal times the demand for payment may increase on account of economic reasons. The banker in order to be on the safe side has to be prepared for these contingencies.

Profits and Safety

The banker is thus divided between two conflicting aims. On the one hand the desire to earn high profits prompts him to use as much of the money under his control as he can, and on the other he wants to make his position as secure as possible against any sudden call to pay an unusual proportion of his obligations.

To make its position secure means keeping of a large proportion of legal tender, which in turn, means so much money lying idle and consequently means loss of profit. The banker has to steer a middle course between the two extremes. And a successful banker is he who has been able to maintain a happy medium. "The most successful banker is he who keeps just enough cash reserve to meet his liabilities and employs the remaining capital entrusted to his care in profitable transaction which, both from the view-point of safety and profit, are bill discounting, loaning on securities or stock exchange collateral and investing in gilt-edged securities. This is the theory of commercial banking put in a nut-shell."[1]

Characteristic of Bank Assets

Unlike other concerns, the essential characteristic of a banker's assets is convertibility into money, and not merely ultimate safety. The assets of the bank may be much greater in value than its liabilities; they may as well be highly remunerative and safe, but if they are not quickly realisable, *i.e.*, if the bank cannot convert them into cash at the shortest notice and thus be in a position to meet its demand obligations, they will be of no real help to it and will not save the bank from disaster whenever an unusual call for payment is made upon it. A banker's obligation is to pay legal tender money on demand, and he must have access to it in any circumstances and without any delay.

Management

The business of a commercial bank is said to be not of a very difficult nature. Good management and goodwill go to make a commercial bank both very successful and very strong. So far as management is concerned, there too, not much skill is needed. The management for instance, of Investment Banks, financing and promoting institutions calls for rare qualities. "The management of a commercial bank is not on the whole very difficult. It calls for prudence, probity, adherence to routine and system, large acquaintance in the business community."[2]

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[1] *Elementary Banking*, Rau, p. 28.

[2] *Principles of Economics*, Taussig, p. 350.

Reputation and Goodwill

Goodwill or high repute is the essential element for the success of a bank. The business of a banker rests entirely upon the confidence in him of the public. This high repute or goodwill can only be attained by a long course of prudent and well-conducted business. But once the goodwill is built up the bank can go on increasing its business, size and profits and it will be difficult for its rivals to compete with it.

Confidence of Customers

We have said above that the modern banking system rests upon the assumption that money deposited by several people is not demanded by all of them at the same time. People, unless they need it, do not demand money, and find it more convenient to let it remain with the bank. And all people do not need money at the same time, while if some have need to demand money, others may have surplus money which they send to the bank, and thus there may not be much difference in its cash. But this will be the state of affairs when things are normal and the confidence which the customers have in their bank is the highest. Any loss of confidence on the part of customers will mean a sudden rush for demands and no bank, however strong, can be strong enough to meet a sudden and a great rush of the kind. It is, therefore, of vital importance to the bank to see that its customers have the utmost confidence in it. There is no reason for people to lose confidence in the bank if they can be sure that their money is safe with the bank or, in other words, if they could know that the bank was carrying on business cautiously, that its assets were of a self-liquidating nature and that it had an adequate cash reserve. To give this information to the public the banks issue their balance sheet every six months or every year.

* * *

How to Scan the Balance Sheet of a Bank

We will now see how to scan the balance sheet of a bank, or how to gauge the position of a bank from its balance sheet.

Percentage of the Reserve to Total Assets

The first thing to be noted in the balance sheet of a bank is the percentage which the reserve bears to the total assets (except bank premises and furniture, etc.). If the reserve is very low it means that the bank has inadequate provision to meet its obligations, and is, therefore, liable to refuse payment in case the demands increase. A high proportion of the reserve on the other hand shows a strong position of the bank in this respect. What actually should be the percentage of the reserve to the assets is difficult to say, for a different percentage will be considered to be safe for different countries and for different places in one country. But if the reserve is less than 25 per cent. of the total assets, the position of the bank in a place like India may be considered to be not quite safe.

Proportion of the Reserve to Current Deposits

The second point to be noted is the proportion which the reserve bears to the deposits on current account. Deposits on current account are demand obligations, and the bank should always be prepared to meet them. And the solvency of the bank depends more than anything else upon its ability to meet withdrawals by cheques. The actually safe percentage of this as well will to a very great extent depend upon the nature of the community that the bank serves.

Proportion of the Reserve Fund and Capital to Liabilities

Besides these two most important points there are other features of the balance sheet which may be well worth observing. The proportion of the reserve fund and the paid-up capital to the liabilities indicates whether or not the bank is doing a large amount of business with a small amount of capital. It is not safe for a bank to do a very great amount of business on a small capital. "If a bank with only a small capital had accepted deposits to the amount of, say, twenty times its capital, it might in the last resort become insolvent even though it did keep a large reserve, and a great part of it in cash. A person who puts his money on deposit in a bank will do well to consider the ultimate possibility of the bank being wound up."[3]

Proportion of Subscribed Capital to Paid-up Capital

The proportion of the amount of subscribed capital to that of the paid-up capital is also of some importance in this connection. If the unpaid portion is large, it is a further security to the depositors in the event of the failure of the bank. If the bank is wound up and if there is a shortage of assets, the shareholders can be called upon to pay the unpaid portion of their shares and this will be utilised in paying the depositors.

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[3] *Money, Banking and Exchange in India,* Jevons, p. 53.

Investments of a Bank

The balance sheet also gives a rough idea about the investments of the bank. A bank which has invested its funds in assets which are not quickly realisable is not doing safe business. In this respect investment in bills of exchange and gilt-edged securities which are readily marketable, is considered to be best from the point of view of safety. But equally unsafe are loans advanced to individual customers for long periods and without good collateral security.

CHAPTER V

THE BUSINESS OF A COMMERCIAL BANK

WE have already seen that the main business of a bank is to receive money and to lend it or transfer it. To study it in detail and also in order to know how a commercial bank actually carries on this business, we shall first see as to how it obtains money and then how it employs it.

The money with which a bank carries on its business consists of (1) its paid-up capital, (2) money deposited by customers in deposit and current accounts, and (3) the money received by selling drafts to persons who wish to remit money to other places.

Deposits

There are various ways in which bank deposits arise. Customers may deposit actual cash or they may send titles to cash, like cheques, bills, promissory notes, owing to them, to be collected and credited to their accounts. Deposits may also arise out of loans granted by the bank, or through the process of discounting customer's bills. In the last case deposits have been created by the bank, and in actual practice the amount of created deposits is much greater as compared with those which are attracted. It is erroneous, therefore, to think that the amount of deposits which appears in the bank balance sheet is so much amount of cash. "These figures do not shew the quantity of cash at the command of the banks to trade with: but they shew the quantity of business they have done, and liabilities they have created. These apparent deposits, then, which so many writers think are cash, are nothing but the credit the banks have created in exchange for the cash and bills which figure on the other side of the balance sheet as Assets."[1] Thus a deposit is not cash, but it is credit. From the view-point of the depositor it is certainly equivalent to cash, but from that of the bank it is simply a liability. So long as it stands, it represents credit based on the confidence in the bank.

Created Deposits

Loans and Discounts Create Deposits

When a bank advances a loan or discounts a bill or promissory note, it does so on the understanding that actual money will not be immediately taken, but that the borrower will have the right to draw cheques upon the bank. This right to draw money from the bank may be created either by the banker or by the customer, but in both the cases the banker must be ready to meet the obligation so created. This liability or obligation of the bank compels it to keep cash with itself. And the greater the magnitude of the deposits, the greater should be the cash reserve; or in other words, the power of the bank to create credit is limited by the amount of cash reserve that it holds.

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[1] *The Elements of Banking,* Macleod, p. 15 5.

Fixed and Current Deposits

From the view-point of the bank out of the three deposits, cash deposits are by far the most important. For, the greater are its cash deposits the greater is its power to manufacture credit and earn profits. In cash deposits also, those which are for a fixed period of time are more important, for in their case the bank has not to meet a demand obligation, and can utilise the whole amount of them for creating credit. In the case of current deposits only a part of the money so received can be utilised for this purpose, and the rest has to be kept to meet the demand obligation for these very deposits. This is the reason why banks allow interest on fixed deposits, and no interest on current ones, while in the latter case some of them require customers to always leave a minimum balance undrawn with the bank. It is, however, the practice with some commercial banks, in India, to allow a low rate of interest on current deposits also. This is in order to safeguard against unnecessary withdrawals. The rate of interest allowed on fixed deposits varies with the market rate of interest and the length of the time for which the deposit is made.

Cash deposited with Bank more useful

Cash deposited with the bank is not only important from the point of view of the banker, but is also regarded as such from that of the community as well. The bank by allowing interest on deposits attracts the small and big savings of the people. And these scattered savings when aggregated and employed by the bank, render great service to commerce and industry. Money lying with the people is idle money, and can serve no useful purpose; it in fact means the depriving of the production of wealth of so much capital.

Creation of Currency

Besides the utilisation by the banks of the scattered savings of people and employing them for productive purposes they create purchasing power or currency: the deposit currency or the cheque currency. The cheque currency not only economises the use of metallic money, but has as well the great quality of being elastic. It can automatically expand and contract with the requirements of commerce and trade.

Bank Drafts

We have already seen in a previous chapter, as to what bank drafts are and how they arise. We have, however, to note here that when a bank gives its draft to some one, it receives cash for that draft. The bank thus creates against itself the obligation to pay the draft when it is presented to it. But for the time between the receiving of the cash and the paying of the draft, the cash remains with the bank, which can utilise it for one or other of its various purposes, and can thus make a profit upon it.

The money received for drafts is in the nature of money received on deposit for a certain period of time, for which the banker can use it in any way he likes. Drafts are thus a double source of gain to the bank. Firstly, the bank charges a commission for issuing the draft, and secondly it gets command of so much cash for the tenure of the draft.

Confidence and Deposits

So far we have seen how a commercial bank gets money from various sources. The paid-up capital of a bank though considerable is only a small amount as compared with its other sources. In fact the bulk of the working capital of a bank consists of its deposits and the sale proceeds on drafts ; and the greater is the amount of these the greater is the power of the bank to serve the community and to earn profits. Every bank, therefore, tries to attract the largest amount of funds, and this depends on the amount of confidence which people have in the bank. It is the reputation of the bank and its comprehensive organization of business, which make it attract the largest amount of funds. Its reputation rests on the soundness of its business, or in other words on the way in which it employs its available funds. The whole secret of sound and successful banking lies in the manner in which the funds of the bank are employed.

How a Bank employs its Working Capital

The banker when he employs this working capital does so with the idea of making a profit, but he has as well to be prepared to meet his obligations. He has to find such means of employing his capital as would be remunerative and would also not lock-up his capital but make it available whenever he may need it. He has, therefore, to choose "Liquid assets, that are readily convertible into legal tender money even in time of panic; which will pay depositors and at the same time permit new loans". We will now proceed to see how the banker chooses his assets and what assets he usually chooses.

Assets of two kinds

The assets of a bank are of two kinds: paying assets and non-paying assets. Paying assets are those on which the banker earns something, more or less. Non-paying assets are those on which the banker earns nothing. The more paying the asset the less safe, or the less quickly realisable it usually is. The banker does not really want to invest his funds in non-paying assets or even in assets which pay less, but he has to do so in the interest of safety, and also in the interest of its reputation, which means more business and consequently more profits. Among the non-paying assets are cash reserve and the bank buildings, furniture, fixtures, etc. The paying assets consist of:-- Loans at call and short notice, discounts, advances, investments and acceptances.

Loans at Call and Short Notice

Loans at call and short notice or demand loans, are loans which are advanced by bankers for a period of three to ten days. In some cases they are lent in the evening and are repayable the next morning. Such loans are subject to call by either party. The bank can demand them whenever it likes, while the borrower can return them at any time. Money on these loans is generally lent to bill brokers and stock exchange brokers, who pledge against it first class marketable securities. The interest charged is generally very low, *e.g.*, 1 to 1½ per cent. But at times when money may not be available in plenty, and the need of the borrower may be very urgent a high interest is paid. Generally the whole amount of the demand loans is withdrawn by the borrowers from the bank, and they are not allowed to be withdrawn by means of cheques.

When the demand for discounting is slack, and banks have plenty of cash they lend freely on demand loans. In this way they employ their cash, which would otherwise be idle and having the right to call back the loan on demand, they can do so whenever they find a more profitable chance for their employment.

Advantages of Call Loans

From the point of view of the banker such loans are considered to be very good. The bank earns something on its money, and at the same time is sure to get back the money whenever it wants it, or in case of failure to pay, the collateral pledged by the borrower can at once be sold and money realised. As Prof. Taussig says, "from the point of view of the bank they are a highly convenient part of its business. A profit is certain, sometimes large, sometimes small, but always appreciable ; and yet the bank's resources are not tied up and cash can be called back—at least by the individual bank—if there is more profitable use for it elsewhere, or if there is a sign of danger. And from the point of view of the public advantage there is also some gain. For sundry useful business transactions funds are wanted over short but uncertain periods, and for them demand loans are adopted". They are also very useful to bill brokers in the conduct of their business. Much of the business of discounting bills is carried on by bill brokers with money borrowed at call and short notice.

Disadvantages of Call Loans

Call loans are, however, not altogether advantageous, they are disadvantageous too ; they encourage and facilitate gambling speculation. When such loans are abundantly available, the activities of the speculators increase and become more reckless. When the banks lend freely on call and short notice the evils of speculation are made greater.

Call loans form a good asset for banks, but not at all times. They are very good assets in normal times, but in times of panic they are useless or become "frozen". At such a time it is difficult to get payment of such loans, and the money so employed is locked up at a time when it is needed most in a liquid form.

Discounts

In modern production and trade the bulk of the business is conducted by borrowing ; and the bulk of the lending is done by banks by discounting commercial paper. It is this which furnishes the largest accommodation to the mercantile community and does most to facilitate operations of trade.

Bills form Good Assets

The reason why discounting plays such an important part in modern production, lies in the excellent qualities that a bill of exchange possesses as a credit instrument. Being negotiable a bill can change hands like the cheque ; and as soon as it is discounted it provides the seller, the exporter or the drawer with cash ; and most of all it furnishes an ideal investment to the banker.

Easily Convertible

A banker, who is always anxious to be ready to face the fact of demand obligations, must have quick assets ; his advances should be for short periods and should be marshalled in such a way that some of them are maturing week by week and day by day. Discounting of bills provides him with the best means to realise this end. For bills mature within a short time, their date is fixed and the banker always knows when his money will come back to him. Again, when a banker discounts or purchases a bill, all rights to the bill are transferred to him ; he can, therefore, if he is in need of funds, rediscount or resell the bill before its maturity.

More Paying

In discounting a commercial paper the banker charges the profit at the time of the advance, and he gains it whether the customer draws out the money or not. Discounting differs from a loan in deducting the discount at the beginning of the transaction, instead of adding interest to the repayment at the end. This makes discount more profitable than interest. The following example will make it clear. Suppose a bank lends Rs. 100 for a year at 6 per cent. interest. At the end of the year it will receive its Rs. 100 back and Rs. 6 more as interest. Its profit will be 6 per cent. But suppose it discounts a bill for Rs. 100 at 6 per cent. In this case it would advance Rs. 94 and at the end of the year receives Rs. 100. Its profit will be 6·4 per cent.

Banks generally discount bills drawn or endorsed by their own customers, about whom they have sufficient knowledge. It will be a risky business for a bank to discount bills without adequate information about the credit of the parties to the bill. Banks which are anxious to do safe business acquire specific information regarding the person upon whom their customers are in the habit of drawing ; they satisfy themselves that they are discounting genuine bills ; and this vigilance in most cases is never relaxed.

Discounting of Promissory Notes

The process of discounting a promissory note is similar to that of a bill, except that the maker of the note stands in the position of the acceptor of the bill. In the case of promissory notes bankers generally ask the customer to get a friend to join with him in a joint and several promissory note, so that action may, in case of dishonour, be taken against either or both for the full amount of the note.

Rate of Discount

The rate at which commercial paper is discounted depends on the demand and supply of such paper. The volume of money in the banker's hand waiting investment constitutes demand, and the briskness or otherwise of trade, which gives rise to such paper determines its supply. When money is plentiful with the banks or when trade is slack and there are less of bills, the rate of discount is generally low, while it is high when money is tight or trade is brisk and the supply of bills great.

So far about the general rate of discount, but it is not necessary that all bills will be discounted at this rate. The time for which the bills run and the credit of the parties to a bill influence to a large extent the rate at which different bills will be discounted. The longer the period and the worse the credit, the higher will be the rate at which such bills will be discounted and *vice versa.*

Loans and Advances

Loans and advances take the form of overdrafts, personal loans and loans on security. They should be distinguished from advances on discounting of bills and loans on call and short notice.

Loans make Deposits

Whatever be the form of the loan, in most cases, it makes a deposit. When a bank grants a loan to a customer it debits the customer with the amount of loan granted and credits him with the same amount in his current account giving him the right to draw by means of cheques as and when required. A loan is thus a book transaction; it creates an asset and a liability at one and the same time. Besides making its own deposits, a loan of one bank may make the deposit of another bank. The borrower who draws cheques on the bank granting the loan, pays those cheques to his creditors, who send them to be deposited with their banks, and thus create deposits with them.

Profits and Loans

The business of granting loans is quite a profitable one for the bank, more so because it lends only credit, which is only transferred from account to account and cancelled through the mechanism of the cheque and the clearing house. But the banks cannot go on extending this credit indefinitely. They have to be aware of the demand obligations which the creation of such credit creates. And their loaning capacity is thus limited by the amount of cash reserves that they hold.

Period of Loans

Loans are generally granted for short periods, for it is not safe business for a commercial bank to tie up its resources for a long time. They are generally granted for a period not exceeding six months, but in some cases they are renewed and allowed to run for two or three years. This is a bad practice, for loans often renewed generally become bad-debts. Again, it is not the business of a commercial bank to lend permanently or for long periods. Bank loans are meant to supplement working capital only; they should not be allowed to become fixed or locked up.

Purpose for which Loans Granted

Banks are cautious in granting loans, and they generally grant them for genuine commercial purposes. It is their business to know, before granting the loan, the purpose for which the loan is taken and when they are satisfied about the soundness of it, then and then only loans within reasonable bounds should be granted. But in practice all banks are not so cautious. When money is plentiful with them, they are not sometimes able to check the temptation of earning high profits and lend money for even doubtful purposes. It is such banks as come to grief early.

Difference between Loan and Discount

Before we proceed to examine the various kinds of loans it will not be out of place to distinguish between a loan and a discount. A loan differs somewhat from a discount. In discounting a commercial paper the bank buys an independently existing and embodied right to demand a certain sum of money. Discounts are not suitable for long-time fixed investments; they are serviceable where capital circulates rapidly. Loans, on the other hand, can be used for any purpose and may run for any length of time. In the case of loans security is more necessary than in that of discounts, because a discount is more secure; in its case the paper discounted holds responsible all parties to it and endorsers. Again, discounting is much more frequent than loans, because the discounted instrument can rapidly be passed from hand to hand.

Overdraft and Loan

We have said above that loans are granted as overdrafts or on personal or collateral security. The difference between an overdraft and a loan is that in the former case the customer pays interest on the daily balance standing to his debit, this being charged half-yearly; while in the latter the customer pays interest on the sum standing to the debit of his loan account, and is required to keep a minimum balance in his credit account. This should mean that an overdraft is more favourable to the customer, but to counterbalance it, the banks generally charge a higher rate of interest on overdrafts than on loans.

Personal Loans

Personal loans may be advanced to customers merely on the strength of their business standing and reputation. A bank may possess a few such customers, whose place in business may be very high, their credit irreproachable and who may be very valuable customers of the bank. To refuse them credit even on their personal security would be incurring their displeasure, and may result in losing their patronage. Such customers, therefore, are advanced loans on their personal security only. In other cases a bank may advance loans on the promissory note of its customer provided the promissory note is signed by one more man of respectability, holding himself responsible to pay in case the drawer fails to do so. The promissory note, when signed by one more person, becomes a 'double name' paper as distinguished from a 'single name' paper.

Cash Credits

Such loans on personal security are, however, granted to customers of highest credit. There is another form of personal loan known as 'cash credits' which are more numerous. The cash credit system is a special feature of the banking system of Scotland and is prevalent to a considerable extent in India also. We have already discussed at length this system in a previous chapter.[2]

Loans on Collateral Security

The next kind of loan, that on collateral security is, however, more important; and the bulk of the loans of a bank is advanced in this form. In this case, loans are made by the banks on the pledge of property that can be sold by the bank if the loan is not promptly paid.

Here the bank does not only rely upon the promise of a person or persons, but over and above it keeps in its possession actual property, which it has the right to sell in the event of default. In this connection the nature of the property which the banks accept as collateral is important. Property which cannot readily be sold or the value of which is not stable, will thus not be the proper sort of security to accept as collateral. Mortgage of real estate, for instance, is the worst security from the point of view of the banker. It cannot easily and quickly be sold, and its value also is not very stable. But many banks accept mortgages as additional security for securing existing loans. This practice is, however, quite safe.

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[2] Refer to chapter on Credit.

Securities acceptable to Banks

There are generally two kinds of securities which are most acceptable to bankers ; stock exchange securities and commercial paper. Amongst these two also, commercial paper is preferable on account of greater stability of its value.

Stock Exchange Securities

But in spite of this, loans on stock exchange collateral are increasing as compared with those on commercial paper. The reason is the scarcity of commercial paper. On account of the popularity of the cheque and the system of telegraphic transfers bills are becoming rare.

Commercial Paper

Among commercial paper, bills of exchange, promissory notes, bills of lading and warehouse receipts are the most acceptable. Money may be borrowed on bills receivable or promissory notes by pledging them as collateral. In case the loan is not paid in time, the bank can either negotiate the bill or note or collect it. In the case of bills of lading and warehouse receipts, the banker, in the event of default, can take delivery of the goods and sell them in the market.

Stocks and Bonds

The more common class of security for collateral loans consists of stocks and bonds. Government stocks, good debentures, stocks and bonds of railways and big industrial corporations and other gilt-edged securities form excellent cover for a banker against advances. They are marketable and their value is more or less stable. For any fluctuation in their value, the banker makes provision by always advancing a lower sum than the value of the collateral pledged. A margin of twenty per cent. of market value above the amount of the loan is usually required, but it may be greater according to the character of the security and its liability to fluctuate in value.

Investments

Next to discounting and loans and advances the bank thinks of employing part of its funds in other ways : ways which may be both remunerative and a source of more permanent income and yet safe. This is done by investing its funds in first class securities which may be easily marketable with the least trouble and risk of loss. Such securities are the Government and other public securities, Treasury Bills, Consols and other British Government Securities, stocks guaranteed by the British Government Indian stocks, Indian Railway Guaranteed stocks and Debentures, British Railway Debentures, and colonial and foreign Government stocks and bonds. A bank invests its funds in many of these securities; no bank holds all its investments in one kind of securities. Such a distribution of its funds among several kinds of securities distributes the risk, a loss on one kind of security may be compensated by a gain on another.

Extent of Investments

The extent to which banks invest their funds in securities is different in different cases. Usually the paid-up capital and the reserve fund are invested in these. As they do not belong to the public nor they can be recalled by the shareholders they can safely be invested in such securities. Over and above these amounts, the bank should be cautious in investing any of its funds in such securities, for the rest of the funds of the bank are repayable on demand, and though in ordinary times such securities are quickly marketable, in a time of panic they (even Government Securities) become unsaleable. The strength of the bank lies in its being strong in times of stress and financial stringency. Besides this consideration almost all these securities are open to the risk of depreciation. And though the bank quotes their value considerably lower than the market value, yet any great depreciation may lead the bank to sustain a loss and to the depletion of its funds. It is safer for a bank, therefore, to chose short-time commercial bills, which though less remunerative yet do not depreciate, than to invest any considerable proportion of its funds in the above manner.

Investments for Short Periods

It should be clear from the nature of the business of such banks, that their investments should not be for a long time. A commercial bank has to keep the supply of floating capital available. It has no business to lock up its capital. Besides this, long-term investments are more subject to depreciation; and also it will be suicidal for a bank to have long-period assets with short-period debts.

Acceptances

Acceptance business, when absolutely genuine trade bills of its customers are accepted by the bank, constitutes a very safe business for a commercial bank. The bank only lends its name to the bill and for this service charges a commission. The bill is no doubt paid by the bank but it is paid with the money which the customer provides before the maturity of the bill. The bank in fact, has nothing to do but to pocket the commission. Its lending its name to or acceptance of the bill, however, makes a hitherto obscure bill prominent and easily negotiable, and also discountable at a lower rate.

Acceptance of Genuine Bills only Safe

In accepting bills the bank is doing safe business only when it accepts genuine bills (drawn against goods) of those of its customers whose credit is sound. But if it accepts kite or many finance bills the business is risky. It has taken upon itself the obligation to pay the bill at maturity and it must pay it whether the customer provides it with cash or not. In the case of bills drawn against goods the customer gets money after disposing of the goods, but in the case of finance bills or kite bills money may not be available to the customer at the proper time. Many banks demand collateral to be deposited with them, before they accept a bill ; so that in case the customer fails to provide the bank with cash, it can sell the collateral and realise the amount for payment.

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Non-paying Assets

So far we have considered how a bank utilises its funds in acquiring paying or profitable assets. We have already said that a bank out of necessity has to sacrifice a part of its profit and utilise a portion of its working capital in keeping non-paying or unprofitable assets. We will now pay attention to the non-profitable operations of a bank. The non-profitable assets of a bank are two : the dead stock and the cash reserve.

Dead Stock, Building, etc.

It includes the building, furniture, fittings, etc., of the bank. Money has to be spent in acquiring these, and a part of the capital of the bank has to be used for this purpose. Whatever amount of capital is invested in these, does not give any return and that is why it is called 'dead stock'. Not much should be spent on this item as the greater the investment on it, the less are funds left with the bank for profitable employment. But the bank should not as well be niggardly. Its building should be strong and imposing. Much of the success and safety of the bank depends upon the confidence which people have in it. An imposing and decent looking building is a sign of prosperity and may be conducive to inspire confidence.

Cash Reserve

The first item on the assets side of the balance sheet given earlier is the reserve, which is divided into three parts. The first part is cash in hand and a portion of the second part is cash at bank. These two items go to make up the cash reserve of a bank. The cash reserve is dead stock, because it is not paying or profitable; it is idle money, money which does not earn anything in the shape of direct profits. The greater the proportion, therefore, of this idle money the lower the direct profits of the bank. The banks, therefore, would wish to keep as little of cash reserve as they can. But it is not so with every bank, and particularly with banks which are big and prosperous. With them an adequate cash reserve is found, and they do not try to reduce their cash holdings to the minimum, and yet the profits of these banks may not be lower than those of others.

A bank for its own safety and existence has to keep a certain amount of cash to meet those of its day-to-day demand obligations, which must be paid in cash. But this is not enough; it should have cash to meet unusual demands, and over and above these it should have more in order to provide cash or credit whenever there may be a greater need for it.

Proportion of Cash Reserve

No hard and fast rule can be laid down as to the proportion of cash reserve that a bank should keep. What is adequate reserve for one may be inadequate for another, while what is adequate for a bank to-day may be inadequate for it tomorrow. Individual banks, by their own experience, find out for themselves the right proportion of reserve which they should keep.

Caution the Essence of Banking

Whatever be found by experience to be the adequate amount of cash reserve for a bank, it must keep it. It must keep it in duty bound to itself, its customers and the community that it serves. It may keep a little more than the adequate amount but never less. It is better and safer to err on the safe side. It is better to sacrifice a little profit, than to court failure and disaster. In the words of Bagehot, "Adventure is the life of commerce but caution if not timidity is the essence of banking".

Safe Business in the Interest of the Bank and the Community

The responsibility of a commercial bank is great. Its existence is highly useful to the community only till it recognises its tremendous responsibility and conducts its business conscientiously, not with a view only to earn profits but also to serve the community. But when a bank by risky business is courting danger, it is not only courting danger for itself but it also courts disaster to the whole community. The failure of one bank may lead to the failure of many more, even of those which are not carrying on risky business. The failure of banks results in a sudden shrinkage of credit and capital, and the whole commerce and industry of the country is for the time dislocated.

Failure of a Bank Causes Far-reaching Effects

When a bank fails, its failure produces a very great psychological effect on the minds of the people, in that they lose confidence in the stability of banks ; and in order to get back their funds safe, they make a rush on their banks for the withdrawal of their deposits. Even the strongest bank is, at times, not able to meet such a rush and has to close its doors. The result is that on account of an indiscreet act or too hazardous policy of a single bank, the whole banking system of the country is upset.

Effect of Financial Crisis

The effect of such a financial crisis is immediate on commerce and industry. They begin to starve for capital ; business for a time comes to a standstill. Besides this immediate disaster, a financial crisis leaves a more permanent effect. The trust which people have lost in banks, cannot be regained quickly. It is sometime before people once again are ready to entrust their savings to banks, and for this time the community loses the use of so much capital, which lies idle.

CHAPTER VI

ECONOMIC SERVICES OF COMMERCIAL BANKS

Usefulness and Strength of Banks depend upon Co-ordination

So far we have seen how a commercial bank carries on its business, and how important a place an individual bank occupies in the sphere of production. The importance of a bank would, however, be far less if it were to stand as an isolated institution. Its importance, usefulness and strength become all the greater on account of the close relation that exists between it and other similar institutions of the country. That country only can boast of the most efficient, the strongest and the most useful banking system, the entire banking system of which is closely linked together, where there is co-operation between various banks and where there exists a central institution which not only brings the individual banking units into closer touch with each other, and helps them in times of stress but also exercises a controlling influence on their policy and on the manner of their conducting business. The two institutions which bring about these desirable results are the 'Clearing Houses' and the 'Central Bank'. Before we go further, therefore, to consider the place of the banking system in the economic life of a country, it will be more useful to know something about these two institutions.

Clearing House

A clearing house is a place where the process of clearing takes place. The process of clearing involves a balancing of reciprocal liabilities with ultimate delivery in cash or its equivalent only of differences. In the words of Prof. Taussig, "A clearing house is a general organisation of banks of a given place, having for its main purpose the offsetting of cross obligations in the forms of cheques."

How it Works

The principle on which the clearing house works is quite simple. Every bank takes to the clearing house all the cheques and bills owing to it and payable by other banks. In return it receives all bills and cheques it has to pay to the other banks. A balance is struck, which is either paid in cash or by means of a cheque on the central bank (where it exists) or on another large bank. This payment by means of cheques obviates the necessity of cash payments even for balances, for a bank which has a debit balance at the clearing house on one day may have a credit balance on the other.

Thus we see that through the mechanism of the clearing house the mutual indebtedness of banks is cancelled, and not a single coin need pass through their hands for this purpose. The credit documents do the entire work of a common medium of exchange, while gold or coin is only used as a guarantee for the capacity of the bank to pay cash if called upon to do so.

The clearing house system is the most developed in England and America. In New York and London more than 95 per cent. of the clearing house exchange are settled by offset. In the Continental countries the cheque currency is not so common as in England, and the clearing houses there are not very popular ; and most of the clearing there is done by the central banks. In India, where as yet neither the cheque is very popular nor much of clearing done, there are at present eleven clearing houses in Calcutta, Bombay, Madras, Lahore, Cawnpore, Delhi, Simla, Karachi, Ahmedabad, Colombo and Rangoon.

Central Bank

The central bank which may be a State-owned or a private concern is in its nature a public institution worked more in the interests of the country than for earning profits. It is entrusted with the power of issuing notes and enjoys certain other privileges, such as keeping Government and bank balances without paying any interest upon them. But if it enjoys these privileges it has to work under certain restrictions from which other banks are free and has a tremendous responsibility in always working in the national interests, both of which go to curtail its earnings.

Bankers to Government and Currency Authority

The central bank being a note-issuing bank has the responsibility of maintaining the stability of the currency ; as the banker to the Government it has to undertake all their financial operations ; and as a bankers' bank, it has to help the country's banks in times of stress, and in normal times to control their activities.

Banker's Bank

Almost all the important banks of a country keep a certain amount of their cash with the central bank. The central bank generally does not pay any interest on such deposits, but in return it renders certain other services to the banks, the most important of which is that of extending accommodation to those banks which may be in trouble. We have said elsewhere that in a panic when there is a rush on the banks, even the strongest bank may not be able to stand such a rush. At such a time it is the central bank which comes to the aid of such banks, the business of which may be quite sound and which may have to face a temporary danger. By rendering this timely help the central bank saves many banks from failure, and saves the country of the disastrous effects of a financial crisis.

Rediscounting

The central bank also rediscounts bills which have been discounted by other banks. On account of the facilities of rediscounting, commercial banks can, whenever necessary, turn into cash a maximum of their assets with a minimum of disturbance to general conditions. "Not until then does the commercial bank's most legitimate asset, *viz.*, a short-term advance against goods in the form of a commercial bill, become a quick asset capable of prompt realisation in terms of stress. The system, in fact, enables the commercial banks to regard their holdings of commercial bills as their secondary reserves."[1]

Co-ordinates Banking

Besides this the central bank brings about a closer relation between the different banks of the country and introduces a sense of co-operation amongst them. Banks which are members of one central bank, keep their cash balances with it and equally rely upon its support and guidance, have cordial relation and close ties among themselves.

Again, the example of the central bank which works in national interest, acts beneficially on the ordinary commercial banks who try to emulate the noble lead.

Controls Activities of other Banks

At times when the banks of the country are manufacturuing credit beyond their means, when many finance and kite bills are being discounted by them and when they are lending money at cheap rates thereby encouraging unhealthy speculation, the central bank comes forward to stop these very risky operations. It does so by raising its own rate of discount which in turn raises the market rate. A rise in the rate of discount reduces the unnecessary expansion of credit and saves the country of a threatening financial crisis.

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[1] *Hilton Young Commission Report*, p. 33.

The central bank is thus an essential part of a well-organised banking system. Without it the banking system will be disorganised; it will be like an army without a general.

Economic Services of a Commercial Bank

Having come to know something about the clearing house and the central bank, we are now in a better position to see the economic services that a commercial bank renders. Like all other banks the commercial bank mobilises the savings of the people. Savings, which are scattered and small, and which cannot serve any useful purposes in that form are collected by the bank for making them more useful. Not only does a bank collect savings, but it also encourages them. People save more because of the existence of banks. No doubt some wealth will be saved even if banks did not exist. But if banks offer definite return, in the shape of interest on savings, and when they provide a very safe place for their keeping, people are induced to save more. Thus banks increase the capital resources of a country and thereby increase production.

Teaches Thrift

People who would otherwise have been extravagant are taught the habit of thrift by bank. Not only this but the possession of a bank account endows a man with moral dignity and stimulates ambition. A man with a bank balance has more confidence in himself, has a greater dignity and may even improve his character. All these are generally conducive to making him a better producer of wealth.

Supplies Capital

The other important service that the bank renders is that it makes available to the community mobilised savings for productive purposes. It supplies capital to those who need it, and but for it this capital could not be acquired directly by many a business man and industrialist. The bank thus makes possible the utilisation in production of huge amount of capital, almost all the available amount, most of which might have otherwise been idle, and to this extent it aids production in a very important way. Besides this it distributes the use of capital according to the relative needs of time and space.

Supplies Inexpensive Medium of Exchange

But the most important service of a commercial bank is to create and provide an inexpensive medium of exchange: credit. It thus not only economises the use of metallic money and thereby saves the community of a lot of inconvenience, risk and expense, but it also increases manifold the work of capital and makes possible the large volume of modern production. "Money means are created, and the command of capital is supplied, without cost or sacrifice on the part of any saver."[2]

Commercial banks primarily facilitate the operations of the active business men. "In so doing, they bring about one clearly advantageous result; they promote the continuity of industry. The merchant or manufacturer who has completed one stage in his operations need not wait, before beginning again, until he has disposed of the saleable product, or received the proceeds of a sale. The bank enables him to anticipate what is due to him or is reasonably certain to come to him, and so enables him to enter forthwith on another page."[3]

A commercial bank by creating credit payable on demand mobilises and applies to production that portion of the wealth of the community which is relatively in a liquid form and which must be preserved in that form. Thus it renders a definite service both to the saver who does not want to invest his savings in fixed investmenlts, and to those producers who are constantly in need of floating capital.

Determines the Right Flow of Capital

Banks lend to those whom they think to be promising; to the incapable they do not lend. This discretion on their part determines the right flow of the community's capital. They put the control of productive energy into the hands of those who will turn it into profitable and useful channels.

Controls the Activities of Producers

A bank exercises a great controlling influence on the activities of producers. By the mere threat of withholding loans or accommodation it can force any business or industrial concern to improve its ways, or to abstain from a risky venture. It can influence its customers to be honest and straight. "There is many a man who would be deterred from dishonesty by the mere frown of a banker though he might care little for the admonition of the bishop."[4]

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[2] *Principles of Economics,* Taussig, p. 351.

[3] *Ibid.,* p. 352.

[4] *Logic of Banking,* Gilbert, p. 117.

CHAPTER VII

GENERAL INTRODUCTORY

Early English Banking—Goldsmiths

BANKING in its modern form is not a very old institution in England; it began to develop there in the seventeenth century. Upto the year 1640 the merchants of England used to deposit their money and valuables in the Mint in the Tower under the protection of the Government. In that year Charles I seized £130,000 in bullion and cash belonging to the merchants. The merchants not finding their money safe in the Tower, developed the practice of keeping their money with goldsmiths. These goldsmiths originally were mere money changers, who now began to receive deposits as well. It was only after some time that they began to lend money and allow interest on deposits. They became money changers on a large scale, and made high profit from the sale of the gold and silver coins they were constantly purchasing and melting down for the purpose. Their manner of attracting deposits was not very honest, and they were not very particular from whom and whence they obtained them. Their ways were crude and their charges exhorbitant; "but they were laying down the foundations of the London Money Market as we know it to-day. In their simple way they were undertaking operations the like of which we see carried on around us at the present time; for they conducted exchange operations; bought and sold metallic money; advanced against security; accommodated merchants by purchasing their bills; and last but not the least, they opened current accounts now kept by our modern joint-stock bankers".[1] As time went on the importance and the banking business of the goldsmiths went on growing. They acted as bankers to the Government and from time to time advanced them money. In 1672 the Government were indebted to the goldsmiths to the extent of £1,300,000. The exchequer not being in a position to pay, stopped payment; this again led to a loss of confidence on the part of financial men in the Government. Public confidence in the goldsmiths had also been shaken on account of frequent failures among them. This led to the public demand for the formation of a public chartered bank on the lines of those which were already in existence in other countries of Europe. From about 1651 to the end of the century proposals to form a central bank had been made many times before the British Government, but for various political reasons nothing was definitely accomplished.

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[1] *The London Money Market*, Spalding, p. 23.

Formation of the Bank of England

In the year 1694 the Government of William III was in urgent need of funds to carry on a war with France. The London merchants had already lost confidence in the credit of the Government and they, therefore, did not come forward to offer loans. This opportunity was availed of by a Scotchman named William Paterson, who offered a loan of £1,200,000 to the Government on the condition that they granted him a Royal charter for the incorporation of a bank, which was to carry on all kinds of banking business, and could issue its own notes to the extent of the loan on the basis of Government securities. The Government accepted the proposal and the Bank of England was incorporated in 1694. The Bank of England was thus the first joint-stock bank to be established in England, and with this exception, banking business was carried on entirely by private banks. The Bank of England being confined entirely to London, banking business in England was practically localised, each town or district had its own local bankers.

Banking in Scotland

In Scotland, on the other hand, a different system had begun to develop. From an early date large joint-stock or shareholders' companies incorporated by Royal charter were formed. "Thus the two systems may be described as a large number of small, local private bankers throughout the country in England while in Scotland it was a small number of large joint-stock banks with branches covering the whole country."[2]

Development of Joint-Stock Banking

This system continued till 1822 when due to a severe fall in the price of corn owing to overproduction and large imports, pressure was brought to bear on the Government to allow country bankers to issue notes. The Government allowed the banks to issue £1 notes; this led to an increase in issue and subsequently resulted in the banking crisis of 1825. In 1826 the "Country Banker's Act of 1826" was passed, providing for the formation of joint-stock banks outside a radius of 65 miles of London. Not much advantage was taken of the Act in the beginning; only eleven banking companies were formed in the first three years; thirty-four were formed in the first seven years; after which they increased more rapidly. In the year 1857 the banks came under the scope of the Joint-Stock Banking Companies Act; and in 1857 for the first time, the principle of limited liability was permitted to them.

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[2] *Mechanism of Exchange*, Todd, p. 122.

Recent Developments in English Banking

Recent development in English banking has been towards the absorption of the country banks by the large joint-stock banks, and the amalgamation of the latter; thus diminishing the number of banks. Since 1914 the tendency towards amalgamation and absorption has been very marked, and big banking institutions with huge capital and numerous branches have taken the place of small banks.

Many of the leading foreign and colonial banks have also established offices in London. They do much of the financing of the English export and import trade and act as agents for their Governments. "They also serve to establish a link with the London Money Market where they employ at times considerable surplus funds, either in short loans or English bills."[3]

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[3] *Practical Banking,* Bagshaw, p. 359.

CHAPTER VIII

THE LONDON MONEY MARKET

Importance of London Money Market

IT has been claimed that the London Money Market is the world's monetary clearing house; and the claim is not altogether untrue. The whole banking system of the modern commercial world is largely dependent on the banking system of London. It is the London Money Market where every country is sure to get funds whenever it needs them, and international payments are generally and more conveniently made through London. It is true that London has lost the supreme importance which it once enjoyed and other important financial centres like New York have become equally important, still the London Money Market is one of the most important financial centres of the world.

Members of the Money Market

"The chief and the most important members of the London Money Market are the banks, bill brokers and discount houses, accepting houses and foreign bankers, all of which are clustered round the central figure, the Bank of England."[1] There is, however, a specialisation or division between home and foreign business in the market. The inner circle which consists of the Bank of England and all the other banks of Great Britain, chiefly conduct the home business. In the outer circle are included all the other banks and financial institutions of all sorts, which carry on the greater part of the foreign monetary business of London. This should, however, not mean that they do not undertake the home business at all. They, in fact, do both; and serve as a connecting link between the two parts of the system.

The Cheque Paying Banks

Taking the banks of Great Britain we find that they are the cheque paying banks which include all the native banks of England except the Bank of England, and do not include the merchant firms and accepting houses (which though do banking business are not cheque paying banks). These banks in the aggregate are the most important members of the Money Market.

Provide Cheque Currency

Their most important function is the creation of the cheque currency which plays such an important part in settling the great majority of commercial and financial transactions, and which, as we will see later, to a very great extent, removes the defect of inelasticity of English Currency.

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[1] *The Meaning of Money*, Withers, p. 106.

Control Day-to-day Rate of Loans

But besides providing the very useful cheque currency, they also in normal times control the day-to-day rate of loans and the discount rates for bills. By normal times is meant the time when the Bank of England does not find it necessary to intervene and control the position. The rate at which they lend money in the market makes the market rate for loans. The market rate of loans means the rate at which the banks lend money—or the right to draw cheques—to the bill brokers; or, in other words, it is the rate for call and short loans.

Regulate Discount Rate

Besides determining the market rate for loans these banks also regulate, in normal times, the discount rate in London. This they do both directly by discounting bills themselves and indirectly through the market rate for loans. For the rate at which the bill brokers will discount bills will depend very much on the rate at which they are able to get money from the banks. Most of the bill brokers are chiefly intermediaries, and discount bills with the intention of rediscounting them with the banks. The banks' rate for discounting bills has, therefore, a great influence on the rate at which the bill brokers will be prepared to discount them.

Supply Credit

Finally these banks provide credit facilities for stock exchange speculation. This they do both directly by advancing loans to their customers on the security of stocks and shares and indirectly by making loans to the members of the stock exchange.

If we are to summarise the most important services that these banks are rendering, they are in the words of Mr. Hartley Withers the following:—

"(1) By providing their customers with cheque-books they create the currency which settles the great majority of commercial and financial transactions and much of the retail traffic of daily life.

(2) By discounting bills and making advances to bill brokers and other customers they create the credits by which commerce and finance are carried on; and these

credits become, in turn, their liabilities on current and deposit account.

(3) They regulate, in normal times, the current rates for money in London.

(4) They regulate, in normal times, the discount rates current in London, which have an important effect on the foreign exchanges, and so on the maintenance of London's gold reserve.

(5) They are large acceptors of bills, and so, again, facilitate commerce and create instruments which are readily convertible into cash or credit.

(6) By advancing to customers or stock-brokers against stock exchange securities they facilitate speculation and thus, to some extent, affect the prices of stocks and shares."[2]

Improvement in English Banking

The improvement in English banking has been greatly due to the improvement and growth of the cheque paying banks, which, in turn, owe their present position to the development of joint-stock banking. The introduction of the joint-stock principle in banking business has subjected it to greater regular working by rule and tradition, and makes it difficult to depart from these rules for the sake of undue gains and thus saves the business from much hazardous venture and from fatal consequences.

Greater Publicity

Joint-stock banks are as well subject to greater publicity than private firms. Banks, when they have to issue periodical statements of their position and Balance Sheets, will always try to keep themselves strong and their business sound in order to infuse confidence in the public.

Bigger Size

Joint-stock banking has also been responsible for the growth in the size of the banking firms and in the development of 'branch banking'. Thus English banking, instead of consisting of a large number of small firms, consists of a small number of big ones, well equipped and well regulated, with branches all over the country worked from one common centre. This development has great advantages, the most obvious being the growth in the size of banks. The business of the banker depends upon public confidence, and the size of the bank is a very important point in this respect. The process of amalgamation and branch building has led both to the growth in the size of these banks and has made them stronger and more efficient; with the result that they are better able to attract public confidence and are less liable to failures.

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[2] *The Meaning of Money*, Withers, p. 219.

The Bill Brokers and Discount Houses

In most of the other countries the business of all discounting is carried on by the banks. In London, on the other hand, most of this business is undertaken by what are known as bill brokers and discount houses. Originally these bill brokers were mere intermediaries between the banks and the merchants who had bills to sell, and they conducted this business for a small commission. Even now some of them still carry on this business and others also carry on similar business with the only difference that instead of working as mere brokers, they purchase bills themselves which they later on sell to or discount with the banks. Such bill brokers, who are also called retail dealers in bills, depend for their funds on the credit advanced to them by the banks; it is only a small amount of their own capital that they use for this purpose.

Discount Houses

The discount houses are a little different from the bill brokers, in this much that though they do a considerable amount of retail business in bills, they are, to a greater extent, permanent holders of bills, and depend to a lesser degree on the advances of banks. The discount houses have larger capital of their own, and also receive deposits, a considerable amount of which they are able to attract by offering a slightly higher rate of interest. This should, however, not mean that they do not at all depend on credit supplied by banks. This they do, but only to a lesser degree than the bill brokers. Thus the difference between the two is one of degree—the extent to which they hold bills permanently and depend on credit obtained from the banks.

Services of a Bill Broker

We see, therefore, that a great part of the business of discounting bills is conducted with the money borrowed in the form of short loans from the banks, *i.e.*, either seven day loans, or day-to-day money or even 'overnight money', which is money lent from one afternoon to the next morning. And we have seen that the bill brokers are chiefly middlemen or intermediaries between the merchants who have bills to sell and the banks which are ready to purchase these bills. But unlike many other kinds of middlemen the bill broker is a highly useful middleman performing truly useful service. The bill broker is a specialist in his business and knows all about the various classes of bills and the parties to them. The banks, therefore, always prefer and find it safer to deal through the bill brokers. The broker also undertakes to endorse a bill if it is unpaid, *i.e.*, he guarantees payment.

His Acquaintance with the Market

The bill broker is in constant contact with the market, he knows the position of the drawers, acceptors and endorsers of the bill. Further, he knows the proportion of the bills of each firm that are current on the market. He is, therefore, always in a position to judge the merits of a bill as soon as it is brought to him.

Facility to Bankers

The bankers find it convenient to deal through brokers as it is comparatively easy when dealing with them, to refuse bills bearing the names of persons with doubtful credit, than it would be if they were dealing direct, for it is not always possible to decline to accommodate regular clients.

Free Market for Bills

This system of bill brokers has created a free market for good bills in London, and all good bills, whether inland or foreign, are quickly sold and purchased without any difficulty. The fact that the sterling bill can be at any time converted into cash in London, has contributed very largely to the world-wide acceptability and negotiability of the bill of exchange of London.

The bill broker, thus, is an important functionary in the field of finance and credit. "The essential difference between him and the banker lies in the fact that the banker makes credit, while the broker sells credit, relying on being able to buy it cheaper. The conditions most favourable to the broker are a high discount rate, which is the price of the credit that he sells, and a low rate for money, or short loans, which are the credit that he buys. But the most important feature in the position of the bill broker is that he constitutes the second line of the banker's defence, and consequently first feels the effect of any monetary pinch."[3] For if money is tight with the bankers, *i.e.*, if they have other uses for money either for their customers or for increasing their first line of defence (cash in hand or at bank), the bill broker is not likely to get enough amount of call and short loans and at profitable rates. And for this reason again, he has always to be on his alert and intelligently watch the movements of the market and accordingly regulate the amount of his business.

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[3] *The Meaning of Money*, Withers, p. 106.

The Accepting Houses and Foreign Banks

We have already seen in earlier chapters that a Bill of Exchange is a credit instrument which plays a very important part in modern commerce and that trade could not proceed with present increasing velocity without the mechanism of the Bill of Exchange. We have also seen how the banks or the bill brokers come forward to discount these bills and thus provide credit or cash to the manufacturers of the bills ; and we have seen while considering the parties to a bill that it generally needs acceptance before it can be discounted. But all acceptors are not of the same reputation and standing ; "and the varying readiness with which certain acceptances were discounted would inevitably express itself in varying rates at which their bills could be placed. It would thus naturally follow that it would profit merchants of second rate standing to give a commission to those whose reputation was more exalted in order to secure a more attractive signature than their own."[4]

Peculiar Feature of the London Money Market

This is how a distinct class of accepting houses has grown up out of the merchant importers, who originally accepted bills in the course of their business. But this development of the accepting houses is a feature peculiar to the London Money Market ; in other countries such an acceptance is undertaken by banks. In London also, as we will see later, some of the acceptance business is done by the home and foreign banks, but most of this work is in the hands of a class of merchant bankers, financiers, and accepting houses, which are private banking firms of first class credit. They are, however, not bankers in the strict sense of the term as they do not pay cheques. The reputation of the accepting houses is so high that their services are used to finance not only the export and import trade of England, but also direct trade between foreign countries.

Their Importance

The importance of the accepting houses is obvious. A banker or broker who discounts the bill cannot be expected always to know the position of the drawer or the acceptor unless they may be merchants too well known in the financial world. But a bill accepted by an accepting house is discounted without hesitation by any bank or bill broker. Thus the accepting houses make possible the circulation of an enormous mass of credit instruments, most of which, otherwise, could at best have only limited currency.

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[4] *The Meaning of Money*, Withers, p. 161.

In recent years the business of acceptance is being undertaken with an increased rapidity by the banks. Other agencies which deal in this business are the Indian and colonial banks, and the agencies of the chief continental banks which play a very important part both as sellers and buyers of bills.

CHAPTER IX

THE BANK OF ENGLAND

Foundation of the Bank of England

As we have already seen the Bank of England was founded in 1694 to finance the government of William III. It was the first English joint-stock bank, and it was intended to give it a monopoly in joint-stock banking in the metropolitan area,[1] by disallowing any other joint-stock bank from issuing notes. But other banks found out that note issuing was not an essential and the most important part of banking business, and thus other joint-stock banks, without the privilege to issue notes, came to be established. The Bank of England in this way secured the monopoly of note-issue instead of that of joint-stock banking.

The original Act of 1694 was amended from time to time, and it was in 1844 that the Bank Charter Act, which is the most important statute regulating banking in England, was passed, and the organization of the Bank of England is regulated by this Act.

A Central Bank : Its Constitution

The Bank of England is the Central Bank of England, the bankers' bank and banker to the Government, but it is a purely private institution owned by shareholders and is managed quite without government intervention. Its Board of Directors consists of men who should not be bankers. The Governors and Deputy Governors, elected by the Board from among themselves, serve for two years. In fact, it is the Deputy Governor who is elected and who, after working as such for two years, becomes the Governor, for no one can become a Governor who has not served as Deputy Governor. The constitution of its Court of Directors and its system of government by rotation have been very much criticised. But the system has its advantages. A board of directors not consisting of bankers will naturally be more impartial than one with bankers upon it. Those banks which have their representatives on the board of the central bank will be in an advantageous position as compared with others. A central bank in order to perform its functions properly must be altogether impartial and free from vested interests. The short tenure of office of the governor has the merit that he is "more inclined to lean on the experience and suggestions of his colleagues on the court, and of the heads of the various departments, and to be less a self-sufficing autocrat than he would probably become if he held office permanently as is often proposed".[2] But whatever be the drawbacks in theory of the constitution of the bank, in practice it has worked perfectly and has shown a record that is not only unrivalled, but is unapproached.

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[1] It covered an area within 60 miles radius from London.

Bank Act of 1844

As has already been said the Bank of England is regulated by the Act of 1844. It will not be out of place to know some of the main provisions of the Act which has brought about an important change in the working and organization of the bank. According to the Act:—

(*a*) The Bank of England was divided into two departments: the Issue Department and the Banking Department. Securities to the amount of £14,000,000 were transferred to the issue department, against which notes were issued and sent to the banking department. Any amount of notes issued beyond £14,000,000 was to be backed by an equal amount of gold and silver, the silver portion not to exceed the fourth part of gold. The business of the issue department was only to issue notes; the banking business to be undertaken by the banking department.

(*b*) It was provided that if any country bank discontinued the issue of notes after 1844, the Bank of England could increase the amount of securities to the extent of two-thirds of such lapsed issue, and to issue notes against it.

(*c*) No more banks could issue notes except those which were issuing them before the passing of the Act.

(*d*) Those bankers who ceased to issue notes were not entitled to renew such issue.

(*e*) Any person could demand notes from the issue department in exchange for gold bullion at the price of £3-17-9 per ounce.

According to the provision (*b*) above mentioned, the Bank's uncovered issue has slowly risen, and by 1923 it became £19,750,000. The notes of other banks have gradually diminished and ultimately they have disappeared. So that at the present day the notes of the Bank of England are the only form of paper currency that is legal tender in England, and the Bank of England is the only joint-stock bank which is allowed to issue notes in London.

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[2] *The Meaning of Money*, Withers, p. 219.

A National Institution though a Private Concern

The Bank of England is a national bank, though so far as its constitution and control are concerned it is entirely a private institution. The Government has no control over it officially ; there is not even a single representative of the Government upon its directorate. It is a private concern owned by ordinary shareholders and yet it is not worked only in the interest of shareholders and for profits. The interest of the public is the first concern of the Bank ; and it has for many years fully realised its responsibility as the official head of the banking community and its policy has always been a national one.

Banker to the Government

The bank holds all the Government accounts or public deposits, and manages the national debt. This means that the bank acts as banker to the Government, and this privilege gives it the prestige so essential for a central bank.

Bankers' Bank

The bank also acts as bankers' bank, *i.e.*, it keeps the balances of other banks, and assumes the responsibility of helping them in times of need. Almost all the important banks of England keep a considerable balance with the Bank of England as their own Reserve. This system is peculiar to English banking and is known as the 'one reserve system'. Unlike other countries where each bank keeps its own reserve here all the banks keep their reserves with the Bank of England, and thus on the one hand strengthen the position of the bank in normal times (for the bank pays no interest on these deposits) and on the other establish a claim on the bank for helping them in times of stress. Thus by this mutual reliance and help the English banking system has gained that solidarity and stability, which make it the most efficient and sound in the whole world.

Ordinary Banking Business

Besides the Government funds and deposits of other banks, many large business houses, public companies and private persons keep account with the bank. These are known as 'private deposits' and as the bank does not allow any interest upon them, the amount of them is not so large as it would otherwise be. Most of the foreign bankers, bill brokers, and other financial institutions also keep a balance, in normal times, with the Bank of England.

Banker to Foreign Countries

Many foreign governments, foreign banks and foreign firms and individuals keep accounts with the Bank of England. London being the most important financial centre for raising government loans and settling financial business, it is advantageous to foreigners to be customers of the Bank of England.

Financing the Government

As against the advantage which the Bank of England enjoys by holding government balances (without interest) it has to shoulder the responsibility of financing the government whenever they are in need of funds. Besides emergency needs, the government are in need of funds every quarter when they have to pay dividends on consols and other government stocks. At such a time the bank lends the required sum or gives the right to draw upon it to the government. The government issue their dividend warrants against this credit. The warrant holders generally send them to their bankers for collection, who in turn send them to the Bank of England, where they are credited to the reserves of the respective bankers.

The advantage that the Bank of England derives from keeping the balances of other banks without paying any interest upon them is not as well without its responsibility and duty. The banks which keep their reserves with the Bank of England consider them equivalent to cash and as the basis of credit that they make. The Bank of England has therefore to keep a large amount of cash in proportion to its own liabilities, and this reduces its power to earn profits.

Currency Authority

The needs of a country for currency are varying from time to time. At certain periods of the year, either at harvest time in agricultural countries or at the end of the quarters when rents, etc., are paid, a greater amount of cash is needed. It is the duty of the currency authority to supply this additional currency whenever it is needed and to withdraw it when it is no more needed. The Bank of England which is the bank of issue has this responsibility of providing the emergency currency. This the bank does without much inconvenience by creating a few deposits in its books. Or, in other words, whenever people want more of money, and when they cannot get it at other banks, they approach the Bank of England, which on the basis of securities of the kind that it approves, lends them its credit, or creates deposits in its books. Credit in the books of the Bank of England is as good as cash, and on the basis of credit so made business transactions take place, through the mechanism of the cheque currency. But it should be noted here that such an expansion of the currency is possible only in England where the cheque is very popular. Such a course would not be possible in other countries where people are less accustomed to the use of deposit currency or cheque. In such countries the currency is expanded by increasing the issue of notes by increasing the fiduciary portion. Such a remedy is not possible in England, for as we have seen, according to the Bank Act of 1844, the fiduciary portion cannot be altered and any note issue above the fixed fiduciary limit must be backed by an equal amount of gold. This is the reason why English currency has been called inelastic. But it is inelastic in theory only ; in practice the currency, deposit currency in this case, is capable of expansion with extraordinary ease and expedition.

Keeper of the Gold Reserve

We have yet to consider the Bank of England's most important function — that of acting as keeper of the gold reserve for the other banks. In fact, the reserve of the Bank of England has come to be regarded as the National Reserve. Few English banks keep with them a legal tender reserve of any magnitude, except a small amount of till money required for day-to-day purposes. They keep their reserves with the Bank of England and impose upon it the heavy responsibility of maintaining the ultimate reserve. And the bank is always alive to this responsibility of keeping itself in a position to meet any ordinary or extraordinary demand for gold whenever it may arise. For this purpose the bank keeps a cash reserve so high as is not kept by any other bank. In normal times it shows a proportion of cash to liabilities about twice as large as shown by the strongest banks and twenty times as high as considered adequate by the weakest. The maintenance of such a high proportion of cash to liabilities means a limitation on the earning powers of the bank'; and the bank is prepared to forego a part of its profits in the interest of the entire banking system of the country.

But besides this responsibility of meeting internal requirements the bank has to face demands from foreign sources and for export purposes. As we have already seen London is the world's monetary market, and most of the monetary transactions of the world are liquidated in London ; besides this it is a free gold market and credits to any extent are granted to foreigners here. The Bank of England which is the custodian of the National Central Gold Reserve has always to guard its gold reserve from being depleted. The bank under such circumstances is compelled to resort to measures to protect its holdings of gold, otherwise the financial stability of the bank and of the country as a whole may be endangered by an excessive depletion. The method usually adopted is the raising of its rate of discount, which tends to raise all the other rates of interest in the money market, thereby attracting foreign floating balances for investment in England, and so inducing an inflow of gold.

Separation of the Issue and the Banking Departments

A peculiar and salient feature of the Bank of England is the complete separation of note issue and deposit. As we have already seen, according to the Bank Act of 1844 the Bank of England was divided into two departments, *viz.*, the Issue Department and the Banking Department. The function of the issue department is only to put out notes. It is strictly regulated by law, and its business is mainly that of the exchange of coin for notes and notes for coins whenever demanded. The banking department, on the other hand, is a pure bank of deposit—the most important bank of deposit in the world. It is entirely unregulated by law, and carries on all sorts of banking business. But as we have seen above, it is so regulated by custom and tradition that it is entirely run in the national interest and not merely for profit. The banking department is normally in the same relation to the issue department as the general public is ; it holds in its reserve notes which the issue department must redeem in specie. Thus what constitutes the assets of the banking department constitutes the liability of the issue department.

The Bank Return

The Bank of England under the provisions of the Bank Act of 1844 is required to issue a weekly statement of its affairs ; this statement is known by the name of the 'Bank

Return'. Since it gives an indication of the state of monetary conditions generally, it has been called the 'Barometer of the Money Market'. It is issued on Thursday each week and appears as follows :—

BANK OF ENGLAND

Week ending Wednesday, November 28, 1928

Issue Department

	£		£
Notes issued	419,088,945	Government Debt	11,015,100
		Other securities	223,568,550
		Silver coin	5,240,157
		Amount of Fiduciary Issue	260,000,000
		Gold coin and Bullion	159,088,945
	419,088,945		419,088,945

Banking Department

	£		£
Proprietors capital	14,553,000	Government securities	52,180,327
Rest	3,254,001	Other securities	33,801,148
Public Deposits	21,452,051	Notes	52,887,797
Other Deposits	99,564,612	Gold and silver coin	757,041
Seven-day and other bills	2,649		
	138,826,313		138,826,313

Notes Issued

The return as given above is published in two parts: that of the issue department and of the banking department. Taking the issue department first, we find that on the debit or liability side there is one item, that of its notes issued. It indicates that up to 28th of November 1928 the bank has issued notes to the extent of £419,088,945. This should not mean that all these notes are in circulation. A large part of them is retained by the banking department in its assets; and in order to find out the actual amount in circulation it should be subtracted from the total issue.

Government Debt and Other Securities

On the assets side of the issue department are the various items on which the bank notes are secured. The first item is the government debt. There is no actual government stock representative of this amount: it simply exists as a book debt on which the government pays 2½ per cent. per annum interest to the bank. The sum under 'other securities' is the amount representing British Government stock, which the bank keeps with it. These two items, the 'government debt' and the 'other securities' form the backing against the 19¾ millions of the bank's fiduciary issue. Above this limit every note must be backed by an equal amount of gold. And the last item 'Gold coin and bullion', represents the amount of actual coin and bullion, which the bank keeps in its vaults as a backing against its notes.

Capital and Rest

Going to the Banking Department, the first item on the liability side is the Proprietors capital, which represents the amount of capital subscribed by the shareholders of the bank. The capital, instead of being in shares is in stock, which is fully paid up. The next item is the 'Rest'. It is the general reserve of the bank and represents the accumulated undivided profits and the balance of the profit and loss account. The Rest is fluctuating from time to time on account of its containing the balance of the profit and loss account. The Rest itself cannot fall below £3 millions, and it has not increased beyond it for many decades. So that any surplus over three million pounds in the Rest is the amount available for dividends to the stock-holders.

Public Deposits and Other Deposits

The next two items 'Pubic Deposits' and 'Other Deposits' represent the sums standing to the credit of the government departments and the deposits of the other customers of the bank (including the balances of the other banks) respectively. Generally public deposits and other deposits vary inversely. The public deposits increase when the government are paying into the bank sums which they have collected from the people in the form of taxes, etc., while they decrease when the government withdraw them to pay dividends on consols and other stocks, which, in turn, are deposited by the receivers in their banks and thus go to swell 'other deposits'. In normal times a high total of 'other deposits' is usually coincident with cheap money and plenty of loanable capital."[5] A high level of other deposits, in general, indicates that the banks have a large surplus of unemployed money; and consequently, there is cheap money and low interest rate in the market.

Seven-Day and Other Bills

The last item, "seven-day and other bills", is not very important. It refers to a form of bill of exchange that is rapidly becoming obsolete. These bills are payable on demand and are usually drawn at seven days' sight. They are issued in amounts varying from £10 to £1,000, and are in the form of promissory notes payable seven days after sight to a specified person or to order.

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[5] *Banking and Currency*, Sykes, p. 199.

Government Securities and Other Securities

Turning to the assets side, the first item is 'Government securities'. It includes the bank's holdings of consols and other British Government Stocks, Treasury Bills, Exchequer Bonds and other securities for short loans to the government. The 'other securities' represent all investments held by the bank, except those advanced to the British Government. Thus they include advances to its private customers, or to bill-brokers, stock brokers, municipalities, colonial governments, accepting houses, colonial or foreign banks, etc.

It should be noted here that unlike other banks, the Bank of England does not show the item 'advances and loans'. This item the bank groups under the two headings of 'securities'. "A rise in Other Securities coincident with a rise in Other Deposits is generally evidence that bankers are strengthening their position. This results in borrowers being driven to the Bank, causing an increase in Other Securities, whilst Other Deposits are increased by the accumulation of funds in the hands of the bankers."

Notes and Gold and Silver Coin

The last two items on the asset side, 'Notes' and 'Gold and Silver Coin', form the Reserve of the bank, which is the most important item since on this depends the stability not only of the Bank of England but of the entire English banking system. This reserve should, however, be clearly distinguished from the reserve of gold held by the issue department; the two are quite separate. By the reserve of the bank we mean its holding of cash in the banking department. We find in the Return that the amount of coin and bullion is proportionately small; the bulk of the Reserve consists of notes. But the notes are equivalent to cash, and in case gold is wanted for them, they can at once be redeemed in the issue department.

In normal times the Reserve was maintained at about 45 to 55 per cent. of the total liabilities, but since the War the proportion has fallen considerably.

Protection of Its Reserve

As we have already seen above, the bank's reserve is liable to be depleted by demands from two sources—

demands for internal requirements and those from foreign sources and for export purposes. These two form quite a heavy demand and the bank has always to be on its guard to protect its Reserve from excessive depletion. The usual method adopted by the bank to do so is to raise its rate of discount or the 'Bank Rate' as it is called, which may raise the market rate, thereby encouraging foreign investments and an inflow of gold.

It will be useful at this stage, therefore, to understand, what is meant by the 'Bank Rate' and the 'Market Rate' and what is the relation between the two. The topic forms the subject-matter of the following chapter.

CHAPTER X

BANK RATE AND MARKET RATE

Bank Rate and Market Rate

"BANK RATE is the official *minimum* rate at which the Bank of England will discount bills. It differs from the market rate of discount in that it is normally higher, and in that it is not a constantly fluctuating rate, shifting with the supply of and demand for bills, but is fixed and announced every Thursday morning at a special meeting of the Bank Court, and except under most unusual circumstances is not changed on any other day."[1] The market rate is, on the other hand, the rate at which the other banks and the bill-brokers are prepared to discount bills. This rate is arrived at by competition among the banks and higgling between them and the bill-brokers on the one hand and the sellers of the bills on the other.

How Bank Rate Controls the Market Rate

At times when money is cheap and on account of the competition between banks and banks and bill-brokers, the market rate is unusually low. When the market rate of discount is comparatively low in London, bills of exchange are sent in increasing numbers from foreign countries to be discounted here. This produces an effect on the balance of indebtedness and the rate of exchange, which moves upwards to the upper gold point, and causes an outflow of gold. Thus the action of other banks and bill-brokers in creating more of credit (by discounting more bills) threatens the depletion of the Bank of England's gold reserve. The bank has to take drastic steps in order to check this depletion ; this it does by making its rate effective in the market. It means then that the Bank of England rate is not always effective ; and this is a fact too. The bank rate is not effective except only at certain periods of the year or when it deliberately makes it so by itself entering the money market. In the words of Withers, "Hence it is that the Bank of England, which is expected to keep a gold reserve for the whole economic body, English and foreign, whence anyone who has a cheque on England can help himself at a moment's notice, is only in exceptional circumstances able to regulate the supply of credit which is based on its reserve."

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[1] *The Meaning of Money*, Withers, p. 223.

When Bank Rate is Effective

These exceptional circumstances, when the bank rate is effective or when the bank is able to regulate the supply of credit, arise on the following occasions :—(1) when trade is very active, so much so that the other banks have been called upon to lend to a very great extent and their lending power has reached its limit, *i.e.*, they are not left with means to lend more. At such a time if more credit is needed it can only be provided by the Bank of England, which does so at its own price and so the bank rate becomes effective. (2) In the January to March quarter taxes are collected by the government; and they deposit millions of pounds with the Bank of England. This means that the credit-making power of the bank is very much increased, while that of the other banks is decreased. Thus money becomes tight in the market and the Bank of England has got to be approached for credit and its rate becomes effective. (3) At the end of the quarters the demand for money and credit is excessive. At this time again the Bank of England is approached and it supplies credit at its own terms.

How the Bank Makes It Effective

Except on these exceptional occasions, the bank rate is not effective. What has then the bank to do in order to regulate the supply of credit and check the rate of exchange from rising very much, at other than exceptional occasions. It has anyhow to make its rates effective and that it does by taking a very drastic step, that of entering the market itself, *i.e.*, directly borrowing in the market money that it does not want. When the bank decides that the conditions of the market make regulation imperative, it borrows money in the money market in order to curtail the mass of credit by other banks. When, on account of the bank's borrowing, money becomes tight in the market, the discount rate goes up and the rate of exchange begins to fall, thus checking the outflow of gold.

Control Greatest at Times of Stringency

Thus we see that the greater the stringency in the money market the greater the power of control of the Bank of England. The people will not borrow from the Bank of England till they can get money elsewhere, because on the one hand, the bank charges a higher rate and on the other, is less accommodating as regards the period of the loan and the security than other banks are. So that at times when all is quiet and money is cheap the Bank of England has no control over the market, but if the outlook becomes really threatening, the bank does obtain such a control.

The Various Rates of the Money Market

We are now in a position to conclude our study of the London Money Market by summarising the various rates prevailing in it, and their mutual relation and dependence.

First, there is the bank rate. Secondly, there is the Bank of England loan rate, which is usually a little higher than its discount rate. Thirdly, there is the market rate of discount which is always lower than the bank rate. There are generally two quotations of this rate—a lower one for first-class bills, and a higher rate for better class bills.

Fourthly, there is the bankers' and brokers' deposit rate. This is the rate of interest paid by other bankers on deposits. It is generally 1½ or 2 per cent. below the bank rate and is regulated by it (the Bank of England does not allow any interest on deposits). The brokers' deposit rate is slightly higher than the bankers' rate.

Fifthly, there is the bankers' call rate and seven-day rate. This is the rate charged for lending money at call and seven days' notice to bill-brokers and others.

Besides these rates there is the rate of interest charged by the banks from their customers for loans and overdrafts. This is not strictly a money market rate, but is influenced by the bank rate. The market rate is always lower than the bank rate and we have already seen how it is controlled when it tends to be much lower. The bankers' and brokers' deposit rates are also related to the bank rate, for a rise in the bank rate results in a rise in these rates also. This will compel the banks to raise the rate which they charge the bill-broker for call and short loans, or else their rate of profit will be curtailed; and when the bill-brokers have to pay more for their money, they, for a similar reason, raise the discount rate.

CHAPTER XI

THE INDIAN MONEY MARKET

THE Indian Money Market consists of the Reserve Bank of India, the Imperial Bank of India, the Foreign Exchange Banks, the Indian Joint-Stock Banks, the Indigenous Bankers and Money-Lenders, Co-operative Banks, Land-Mortgage Banks and Industrial Banks on the one hand, and the borrowers of money and credit on the other. The borrowers include the Government of India, who annually float rupee loans in summer months, the traders, merchants and industrialists, the agriculturists—both cultivators and landlords—and the Indian people who need money for various social and religious purposes. The business of the money market is to supply credit to all these borrowers.

The banks in India are divided into different types, each doing a definite and distinct type of business. In practice, there has undoubtedly been overlapping of work as between these various types, but in the main, the distinction is too well marked. The Imperial Bank acted as banker to the Indian Government and kept Government balances without paying interest. It also finances the internal trade and commerce to a certain extent and with its large liquid resources and favourable position as banker to the Government, acted to a small extent as bankers' bank, and thus in co-operation with the Government it controlled the money market in India through the bank rate. It was not allowed to do exchange business in which the Exchange Banks have a monopoly. The business of financing foreign trade is practically in their hands. The Joint-Stock Banks, along with the Imperial Bank, confine themselves to the financing of internal trade and commerce. The indigenous bankers and money-lenders finance the bulk of the internal trade and agriculture, which is to a limited extent also financed by co-operative banks. The Tata Industrial Bank was the only important industrial bank; and that too has been amalgamated with the Central Bank of India. The Land Mortgage Banks which are yet very few in number, advance long-term loans for agriculture.

The Indian banking organization is a decentralised one. There is too much specialisation and too little co-ordination, with the result that each institution has to rely upon its own resources and has to face the dangers of a financial crisis single-handed. But though there is so much of unnecessary and injurious specialisation in types of banks, credit has not been thoroughly specialised in all its various forms. It is generally divided into long-term credit and short-term credit. Long-term credit, which is rapidly non-developed, is undertaken by *Mahajans* who charge very high rates of interest. Short-term credit, except for a few joint-stock banks, is in the hands of usurious money-lenders, who are a menace to both agriculture and small industries.

Though the types of banks above enumerated are many and their number, according to the last census report, considerable, yet there is not plenty of loanable money in the market to satisfy the demand. The loanable capital of the country is not even adequately mobilised by the banking organisation, much less to say of the development of the money power of the country. The indigenous bank ker does not receive deposits, as a rule, the joint-stock banks have not realised the value of small accounts and never have attempts been made to discourage people in their hoarding habits. With the absence of a Central Bank till recently each bank had to keep a large amount of till money and reserve which could otherwise circulate in the shape of credit.

The credit system, besides its inadequacy, is not elastic. Any extra demand for currency cannot be met by the expansion of bank credit. The Indian banks, on account of the necessity of keeping large cash holding against demand obligation, are hardly in a position to expand credit to an appreciable extent. The result is that our money market is not stable. The rapid fluctuations in the discount rate of the Imperial Bank amply demonstrate this. Such a fluctuation introduces an element of uncertainty in commerce and industries, and they cannot certainly flourish when the fluctuations in the rate of discount are so rapid and great.

CHAPTER XII

THE IMPERIAL BANK OF INDIA

Origin

THE Imperial Bank of India is of a recent origin. Before 1921 it did not exist, but in its place were the three Presidency Banks . The Bengal Bank, The Bank of Bombay and the Bank of Madras. These banks were ordinary joint-stock banks, with the only difference that they transacted Government business, and had to submit to certain regulations imposed by the Government in the conduct of their banking business. These three Presidency Banks were amalgamated in 1920, and by the Act of 1920 (The Imperial Bank of India Act) the Imperial Bank was created. "The basis of the amalgamation was that the three Presidency Banks were taken over by the Imperial Bank as going concerns with all their assets and liabilities, their premises and their staff of employees. Even the whole of the Directors of the Presidency Banks were to continue serving as members of the Local Boards of the new Bank."[1]

Capital

The capital of the Imperial Bank is Rs. 11,25,00,000 divided into shares of Rs. 500 each, while the capital of the three Presidency Banks was Rs. 3,75,00,000. The shareholders of the Presidency Banks exchanged their shares for those of the Imperial Bank and thus automatically became shareholders of the Imperial Bank. The increased capital was issued for subscription by the public, and in this also the shareholders of the Presidency Banks were given the first choice to subscribe.

Constitution

The Imperial Bank has not got a general Head Office, but has three local Head Offices at Calcutta, Bombay and Madras and the annual meeting of the shareholders is held in rotation at these three places. The control of the Bank is entrusted to a central Board of Governors with local Boards at Calcutta, Bombay and Madras, and such other places as the Central Board, with the previous sanction of the Governor-General-in-Council, may determine. The Central Board of Governors consists of :—

(*a*) Managing Governors, not exceeding two in number, appointed by the Governor-General-in-Council on the recommendation of the Central Board.

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[1] *Money, Banking and Exchange in India*, Jevons.

(*b*) The Presidents, Vice-Presidents and Secretaries of the Local Boards.

(*c*) The Controller of the Currency, or any other officer nominated by the Governor-General-in-Council. And

(*d*) Not more than four non-officials, nominated by the Governor-General-in-Council.

The Controller of the Currency and Secretaries of the Local Board are entitled to attend the meetings of the Central Board but not to vote.

Management

The management of the Bank is in the hands of the principal salaried officers. The two Managing Governors and the three Secretaries, who are paid officers, along with Managers, Inspectors and Accountants, carry on the work of administration. There are no President and Vice-President of the Imperial Bank as a whole, but at each meeting of the Central Board, they are elected by the Governors present from among themselves.

Government Business

The Imperial Bank of India Act follows the Presidency Banks Act in defining the business in which the Bank may engage. Some of the older limitations have, however, been modified in the new Act; and accordingly, the Bank is allowed to open a branch in London and to borrow money in London on Bank's assets; but it cannot offer cash credits, keep cash accounts, or receive deposits in London except from the old customers of the Presidency Banks. The Act provides an agreement between the Bank and the Secretary of State. The agreement, which was signed on the 27th January 1921 and was for a period of ten years, provided[2] :—

(1) All the general business of the Government of India is to be carried out by the Imperial Bank.

(2) The Bank will hold all the Treasury Balances at Headquarters and at its Branches. This involves the abolition of the Reserve Treasury System.

(3) Within five years the Bank undertakes to open hundred new branches, of which the Government of India may determine the location of one out of the four.

(4) The management of the public debt will continue to be conducted by the Bank for specified remuneration.[3]

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[2] *Indian Year Book.*

[3] A commission of Rs. 2,000 per crore per annuam. Rs. 3,000 per crore per annuam if the bank manages the debt of Local Governments.

Other Business

The business that the bank can transact is defined in Schedule 1 of the Act. The main classes of business sanctioned under it are:—the advancing of money upon the security of trustee stocks, railway securities, debentures and other securities issued by District Boards, goods or documents of title deposited with the Bank, accepted bills of exchange or promissory notes, and fully paid shares and debentures of limited companies as collateral; the drawing, accepting, discounting, buying and selling of bills of exchange and other negotiable securities payable in India and Ceylon; the discounting, buying and selling of bills of exchange outside India for and from approved banks; the issuing of Bank Post Bills and Letters of Credit payable in India and Ceylon; the buying and selling of gold and silver; the receiving of deposits; the receiving of securities for safe custody; the transaction of agency business on commission; the borrowing of money in India and in England (only on the security of the assets of the Bank, but not otherwise).

Restrictions on Its Business

The Imperial Bank thus performs the same kind of business which the Presidency Banks performed. Though some of the restrictions have been slightly modified, they are in nature almost the same; to place a check upon its undertaking unsafe business. The principal restrictions placed on the business of the Bank in Part 2 of the Act are the following:—The Imperial Bank shall not make any loan or advance (*a*) for a longer period than six months; (*b*) upon the security of stock or shares of the Bank; (*c*) save in the case of courts of ward estates, upon mortgage or security of immovable property or documents of title thereof. The amount which may be advanced to any individual or partnership is limited. Discounts cannot be made or advances on personal security given, unless such discounts or advances carry with them the several responsibility of at least two persons of firms unconnected with each other in general partnership.

Work as a Central Bank

The Imperial Bank of India was thus constituted to serve as a Central Bank and a Bankers' Bank. It was in sympathy with the popular demand for a Central Bank that the three Presidency Banks were amalgamated to form one big institution with a national outlook, and a strong position to be able to help other banks in times of distress and exercise a controlling influence on their.

activities. But experience has shown that none of these hopes has been realised. The Imperial Bank could not serve as a Central Bank. It worked as an ordinary commercial bank, which transacted Government business also and which on account of its advantages in keeping Government balances was a formidable rival to other commercial banks in their business, and which instead of being regarded as a friend, guide and philosopher, was looked upon with an eye of suspicion and rivalry by other banks of the country.

Control Over the Money Market

Unlike the Central Banks in other countries the Imperial Bank was not allowed to issue notes. Thus it had no power to influence the volume of currency in India and consequently was unable to control the money market in the manner in which the Bank of England or the Bank of France can through its rate of discount. The Imperial Bank could still control the market rate by its direct participation in the exchange business; but here its charter precluded it from such business. It is argued that exchange business is risky and should not be undertaken by a Central Bank, and that the Central Banks in other countries are, therefore, not allowed to enter this business directly. This is true; but those banks have the power to influence the volume of currency, "and we must not overlook their indirect, but not less effective powers of control over the foreign exchange business. By a sudden and sharp rise in its rate of discount the Bank of England could, in normal times, easily and effectively redress any inconvenient temporary aberration in exchanges. The Imperial Bank of India is precluded from direct dealings; and has no means of effective control indirectly."[4]

One-sided Activity

The duty of a Central Bank is to act as a central bank for the banking system of a country. The banking system of a country does not only consist of commercial banks, it consists of industrial, exchange and agricultural banks also. The Imperial Bank's activities were confined only to commercial banking. "Without an industrial and agrarian side; without the power to regulate our foreign exchanges, or the right to control our currency system, the Imperial Bank of India can at best be of limited utility in commercial finance."[5] And in this field too its utility, on account of an ineffective bank rate, which is generally high, was not appreciable.

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[4] *Indian Currency, Exchange and Banking*, Shah, p. 334.

[5] *Ibid.*, p. 336.

Non-Indian Policy

Over and above these the Imperial Bank's directorate and management are preponderatingly non-Indian. The interests of the country of the foreigners may at times be against those of India and the interests of a bank chiefly controlled and managed by English men can hardly be identical with those of India. This has been the chief reason that the Imperial Bank has not very often evidenced any broad national outlook for the country's economic well-being, nor shown any sympathy for the advancement of national banking.

Bank Rate

The rate at which the Imperial Bank was prepared to lend money on Government security was called the bank rate. The discount rate is slightly higher (by 1 or 1½ per cent.) than the bank rate. "The discount rate is usually higher in winter and early spring ranging from 6 to 9 per cent., and low in summer, say to 5 per cent."[6] The rate rises and falls with the demand for money. When the demand for money is great the rate is high and *vice versa*. Thus a high rate shows that the business being transacted by the bank is considerable and a low rate that the business of the bank is slack.

We have seen in the case of the bank rate of the Bank of England that it controls the money market in London through it.[7] The same cannot be said of the Imperial Bank rate. It did not control the money market in India. Besides this the Imperial Bank rate was never as low as the bank rates in other countries, and was generally fluctuating.[8] Both these facts made the bank rate very in-

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[6] *Present-day Banking in India*, Rau, p. 25.

[7] *The Meaning of Money*, Heartley Withers.

[8] *Bank rates of the Imperial Bank of India from* 1921-30

Year	Half-year ending 30th June	Half-year ending 31st December
1921	6·04	5·11
1922	7·13	4·51
1923	7·42	4·50
1924	8·05	5·32
1925	6·58	4·70
1926	6·65	4·70
1927	6·51	6·96
1928	6·94	5·46
1929	6·88	5·79
1930	6·51	5·28

effective and less useful. But for this the Imperial Bank was not to blame. The Imperial Bank was not truly a central bank which can be effective in controlling the money market.

The New Act

With the establishment of the Reserve Bank of India the Imperial Bank was relieved of its central banking functions and it was, therefore, thought necessary to free its business from the various restrictions imposed earlier. With this end in view the Imperial Bank of India Act (1920) was amended and altered and these amendments were incorporated in the present Act which received the assent of the Governor-General on 6th March 1934, and which came into force subsequently.

Some of the important provisions and amendments of the Act are as follows :—

(*a*) The Imperial Bank is authorised to enter into an agreement with the Reserve Bank to conduct Government business as agent to the Reserve Bank.

(*b*) The limitations on the business which the Bank may transact at its London office have been removed and it has been given specific powers to open branches outside India, in London and elsewhere.

(*c*) The Bank is allowed to do foreign exchange business and it has been given extended powers in regard to its internal business. "For instance, the Bank can advance and lend money and open cash credits upon the security of the shares of the Reserve Bank ; upon debentures or other securities for money issued under the authority of any Act of a Legislature established in British India by, or on behalf of a municipal board or committee or with the sanction of the Governor-General-in-Council, upon debentures or other securities for money issued under the authority of a Prince or Chief of any State in India and debentures of companies with limited liability whether registered in India or elsewhere subject to the directions of the Central Board. It can also lend money and open credits upon the security of goods which are hypothecated to it as security for such advances, loans or credits, if so authorised by the special directions of the Central Board. According to the Act of 1920 the Bank could not grant loans for more than six months; but the new Act allows it to make advances for nine months for financing seasonal agricultural operations. It also allows the Bank to acquire and hold movable or immovable property as security for any loan or advance."[9]

(*d*) The constitution of the Bank is also changed and according to the change the Central Board shall consist of the following :—

(1) the presidents and vice-presidents of the Local Boards established under the new Act ;

(2) one person to be elected from amongst themselves by each of the local boards ;

(3) a Managing Director to be appointed by the Central Board for five years ;

(4) persons not exceeding two in number and who may not be Government officers may be appointed by the Governor-General for one year, but who may be re-nominated;

(5) a Deputy Managing Director to be appointed by the Central Board (he will not have the right to vote except in the absence of the Managing Director) ;

(6) the Secretaries of the Local Boards (will not have the right to vote) ; and

(7) 'if any local board is hereafter established under this Act, such number of persons to represent it as the Central Board may prescribe.'

According to the Act of 1920 the controller of the currency was an *ex-officio* member of the Central Board and the Governor-General-in-Council nominated four other members to it. According to the new Act the controller of the currency ceases to be a member and the Governor-General can nominate only two members. This indicates a lessening of the control of the Government over the operations of the Bank.

(*e*) The power of the Governor-General to demand any information from the Bank is removed, but the power to appoint auditors to examine and report on the accounts has been retained. This power is retained in order to enable the Governor-General to examine the affairs of the Bank since the agreement with the Reserve Bank is conditional on the maintenance of sound financial position by the Imperial Bank.

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[9] *The Indian Money Market*, by Krishna Kumar Sharma, p. 285.

CHAPTER XIII

INDIAN JOINT-STOCK BANKS

History of the Growth of Joint-Stock Banks

BANKING on modern lines was first introduced in India by the so-called agency houses in the beginning of the nineteenth century. These agency houses, which were formed by the retired civil and military employees of the East India Company, carried on banking and commercial business side by side, and these came to grief in the wake of the failure of the mercantile firms and Indigo houses in 1829.

1834 to 1857

After this period the following banks, which carried on purely banking business, were started: The Agra Bank, 1833; The Simla Bank, 1844; The London and Eastern Bank, 1854; The Commercial Bank, 1854; The Dacca Bank, 1846. These banks, on account of the apathy of the Court of Directors of the Company, could not develop their business satisfactorily.[1]

1857 to 1900

Over and above this came the Mutiny of 1857 which unsettled the country for a time and banking development was also checked. After some time banking development again started and some important banks were established: The Allahabad Bank, 1865; The Alliance Bank of Simla, 1874; The Oudh Commercial Bank, 1881. The Oudh Commercial Bank was the first joint-stock bank started by Indians. At about this time some other joint-stock banks, as The Punjab National Bank, The People's Bank and The Amritsar Bank, were also started. In the beginning of the present century, on account of the 'Swadeshi' movement, many indigenous joint-stock banks came into existence; and later on, the general prosperity of Northern India led to a further investment of capital in banking business.

1900 to 1913; *Banking Crisis of 1913-15*

The period from 1900 to 1913 saw the mushroom growth of banks in India. And by the year 1917 India had as many as 88 Indian joint-stock banks with 199 branches.[2] Poeple thought that bank business was a sure way to get rich quickly, and with this idea large and small banks, many with insufficient capital and incompetent management, were started. For some time these banks made very great strides, but with their defects this position could not continue for long, and many of these banks were put to a severe test in the crisis of 1913-15. The first important failure to take place was that of the People's Bank of India, and the loss of confidence caused by its failure resulted in a very large number of other failures; the principal being that of the Indian Specie Bank, the Standard Bank and the Bank of Upper India, Meerut.[3] The crisis of 1913-15 was the most severe that India ever experienced. As a result of it about 34 per cent. of the total paid-up capital of Indian joint-stock banks was lost.

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[1] The East India Company was a trading organization, and carried on commerce and exchange business in India. Any rivals in its business were not, therefore, looked upon with a favourable eye.

The banks which failed during 1913-17 caused the country a loss of no less than 51 per cent.[4] of the total paid-up capital of all the joint-stock banks surviving in 1917. The following table[5] will give an idea of the extent of the loss :—

LIQUIDATIONS

Capital (in lakhs of Rupees)

Year	Number	Authorised	Paid-up
1913	12	2,74	35
1914	42	7,10	1,09
1915	11	56	5
1916	13	2,31	4
1917	9	76	25
TOTAL ..	87	13,47	1,78

Most of the institutions which failed during this period were small and weak but the following big banks also failed in their wake.

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[2] *Indian Finance and Banking*, Findley Shirras, p. 364.

[3] *Indian Year Book*.

[4] *Statistical Tables relating to Banks in India for* 1917, p. 2.

[5] *Indian Finance and Banking*, Findley Shirras, p. 366 (as quoted by Jain, *Monetary Problem of India*, p. 90).

Paid-up Capital (in lakhs of Rupees)

1.	The Indian Specie Bank ..	.. 75
2.	The People's Bank ..	.. 13
3.	The Credit Bank of India ..	.. 10
4.	The Standard Bank of Bombay ..	.. 10
5.	The Bank of Upper India ..	.. 10
	TOTAL	.. 1,18

Causes of Bank Failures

The causes of these failures were many and some of them were out of the control of the banks themselves, but the chief cause of the failures was mismanagement due to inexperience in banking business. The managers were generally incompetent and the directors mostly were ignorant of the principles and theory of banking, with the result that some of the banks carried on speculative business, most of them paid very high rate of interests on deposits,[6] and many of them invested their resources in fixed assets not quickly realisable.[7] In some cases the percentage of the cash reserve to the liabilities was very low (in some cases as low as 10%). "Many of the banks had inadequate reserves against their deposits, and the balance sheets were in several cases good examples of window-dressing. In 1910, for example, the percentage of cash to liabilities on deposits was only 11, and in very many cases, the percentage was lower than this. This is hardly sufficient, having regard to local conditions, for these pigmy banks, since it was the pigmy banks that came to the wall. Many had an imposing capital but little paid up. The word 'bank' was used in a way that exploited deposits from the unwary at rates of interest which made it impossible for money so obtained to be employed lucratively in any way, except in the most hazardous enterprises. In one or two cases, banking, as we have seen, included medical attendance, coach building, etc."[8]

Other Causes

But besides these causes, there were others too and for which banks which failed were hardly responsible. The jealousy and disfavour with which the Indian banks were viewed by the old banks, and the various means adopted by these to discredit and unpopularise the country's banks accelerated their downfall. These old banks, and the Pre-

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[6] In the Punjab as high as 8% interest was allowed on deposits.

[7] Many liquidated banks paid in full. Thus their assets were not less than their liabilities, only they were not quickly realisable.

[8] *Indian Finance and Banking*, Findley Shirras, p. 365.

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sidency Banks, which claimed to occuy the position of banker's banks, refused to give any help to these banks in their trouble. The exchange banks were jealous of the Indian Specie Bank, for its opening a branch in London to carry on pearl and silver business. The exchange banks resented competition, and the rate cutting that they adopted was responsible for the failure of the Indian Specie Bank.

In fine, the causes of the bank failures were, (*a*) the inexperience of Indians in the business of banking, (*b*) inadequacy of legal restrictions on the activities of the joint-stock banks, (*c*) the apathy and unsmypathetic attitude of the foreign banks and the Presidency Banks, and (*d*) the absence of a strong central bank, and of an organized and co-ordinated banking system in the country.

Lesson given by the Crisis

The crisis of 1913-15 had, however, a great educating effect. The defects in our banking system were brought home to the people and to the Government, and an all-round demand was made for the reform of the system. Banks, which on account of their weak position and bad management had no right to exist, went to the wall. Those which could survive became more cautious in their business and recognised the necessity of employing trained staff.

Need of Banking Training

But, unfortunately, trained staff and experienced men in banking were hardly available in India. In every country there are facilities provided for the training of young men in banking business. Banks train apprentices in their offices. The Institute of Bankers and other similar bodies hold examinations, and the universities provide training in commercial and financial subjects. To some extent a step has been taken in this direction in India also. Some of the Universities have opened commerce classes, an Institute of Indian Banks has been established which holds examinations, and a few banks have begun to give training to young men desirous of seeking employment in banks. But all this has touched only the fringe of the problem and there is still a very great need and scope for increasing facilities for both practical and theoretical training of Indians in banking.

Need of Banking Legislation

But mere training of bank staff will not stabilise the banking system, unless there are common legal restrictions imposed on the activities of the banks. In India unfortunately there is no special legislation for banks. The Indian joint-stock banks are incorporated under and governed by the Joint-Stock Companies Act of 1913. Banking business is essentially different from commercial or industrial business. Rules which are meant for commercial or industrial business cannot be suitable and adequate for banks. In every country banks are governed by special legislation in the interest of the country as a whole. Credit is the pivot on which the entire machinery of modern commerce and industry revolves. In the development and stability of banking lie the development and stability of these. It is in recognition of this truth that banks are not allowed to have their own unrestricted way in their business. In India the plea for banking legislation is even greater. India' s banking is yet in its infancy and any false move at this stage will be a great impediment in her banking development. It is repeatedly pointed out that Indians lack in banking habit and that Indian capital is shy. These shortcomings can be overcome by infusing more confidence in the minds of the people in the stability of our banks. Such a confidence cannot be created unless the banks' activities are properly supervised and regulated.

Safeguards of Sound Banking

"It would be to the advantage of Indian Joint-Stock Banks if the safeguards of sound banking were adopted, *e.g.*, (1) the restriction of the term bank to banks proper ; (2) the advantage of having, as in the Canadian system, a minimum paid-up capital before the bank opens its doors to do business; and (3) restrictions by law in the granting of loans and discounting paper. Legislation seems also required in connection with the investments of banks. Some banks invest too largely in real estate, and even in unsound securities."[9] Over and above these, a minimum percentage of profits should be required every year to be carried to the Reserve Fund in order to build up a decent Reserve Fund in a short time. The banks should be required to give greater publicity of their position and their operations than they are at present required to do, under the Companies Act. And the directors, the managers and the auditors of the banks should be held personally liable for deliberate fraud or manipulation of accounts, and these should constitute as criminal offences.

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[9] *Indian Finance and Banking,* Findley Shirras, p. 431.

Necessity of a Central Bank

Next, in order to further stabilise and organize the banking system, a central bank, with powers of issuing notes, providing rediscounting facilities and acting both as Government's bank and banker's bank, is very necessary. Without a central institution, strong enough to provide help and protection to other banks during difficulties, exercising control over their activities and co-ordinating the entire banking system of the country, no individual bank can be strong enough to face exceptionally abnormal periods. A central bank—a friend, guide and philosopher in one—is an inevitable necessity in modern banking. This great need has, however, been fulfilled, by the recent creation of the Reserve Bank of India. And it is hoped that the creation of the Reserve Bank will go a long way in not only making the position of the joint-stock banks more stable and secure but also in organizing the entire banking system of the country on better lines and in leading to its rapid and all-round development and growth.

Present Position of Joint-Stock Banks

The position of the Indian joint-stock banks at the present time is, however, not as satisfactory as it should be. The proportion of the cash to their liabilities is a fair index of their strength or weakness. The following table[10] gives an idea of their position for the five years, 1926-30.

Percentage of Cash to Liabilities on Deposits

Joint-Stock Banks	1926	1927	1928	1929	1930
	%	%	%	%	%
(A) Capital and Reserve over 5 lakhs	15	13	13	14	12
(B) Capital and Reserve between 1 and 5 lakhs	24	15	15	13	12

The above figures indicate not a satisfactory proportion of cash to liabilities. For a country like India, a higher proportion is certainly necessary for inspiring confidence in the public and for strengthening and stabilising the position of the banks.

It will be more useful in this respect to examine the position of some of the leading banks of India. The following table[11] shows the position of the better known existing banks as it appears in the latest available Balance Sheets :—

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[10] *Statistical Tables relating to Banks in India.*

[11] *Indian Year Book.*

(In Lakhs of Rupees)

	Capital	Reserve	Deposits	Cash and investments
Allahabad Bank, Ltd. ..	35	44	1,081	706
Bank of Baroda, Ltd. ..	30	21	539	411
Bank of India, Ltd. ..	100	100	1,449	1,070
Bank of Mysore, Ltd. ..	20	20	193	93
Central Bank of India, Ltd.	168	70	2,222	1,686
Indian Bank, Ltd. (Madras)	12	15	172	22
Union Bank of India, Ltd...	39	7	58	68

Even these big banks are like pigmy banks as compared with big banks of foreign countries from the point of view of their resources and business. As regards their reserve position except for the Union Bank of India, the reserve position of the rest is quite fair, but not quite as satisfactory as of the English Banks.

Business of the Banks

The Indian joint-stock banks do not finance agriculture which is financed by the indigenous bankers, the money-lenders and to some extent by the Co-operative Credit Societies. They do not as well concern themselves with the foreign exchange business for which there are exchange banks. Nor do they finance small artisans and traders who cannot give approved security. The Indian joint-stock banks chiefly conduct ordinary commercial banking business in the Presidency towns and large commercial centres. Their business is thus to finance the internal trade and attract deposits. Generally interest at the rate of 3 to 5 per cent. is allowed on fixed deposits for periods above six months; and an interest at the rate of 1 or 1½ per cent. is allowed on current accounts by some banks only. The minimum monthly balance of current accounts on which the banks insist varies from Rs. 100 to Rs. 300. Some banks do not allow any interest on current accounts. Some of these banks have opened savings banks departments also, some have introduced the Home Savings Safes,[12] and some of them also deal in the purchase and sale of gold and silver bullion. Loans are advanced for short periods on the security of commercial paper, stock exchange collateral and in some cases on personal security and security of property. They discount bills, and many of them also purchase hundis. Besides these they carry on other banking business also such as the use of drafts and letters of credit, collection of dividends and debts for customers, distribution and payment of premium on behalf of customers, and keeping jewelry and other valuables and documents of customers in safe custody.

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[12] The Central Bank of India has introduced it. A small iron safe is given to the customer which he takes home and in which he may drop through the slit, day-to-day savings. The safe is brought to the bank at intervals and the money is taken out and credited in the account of the customer.

Remittance Business

These banks, along with the Imperial Bank, undertake a considerable amount of remittance business. They buy and sell remittance at market rate, but the rates may vary from client to client, and are generally the same as of the Imperial Bank, where they have to face competition with it; in other places their charges are often higher. Usually ¼ per cent. to 1/32 per cent. is the rate charged on such remittances—the rate being lower for larger amounts.[13]

Slow Growth of Commercial Banking in India

The growth of commercial banking in India has been rather slow.[14] The number of commercial banks taking

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[13] *U.P. Provincial Banking Enquiry Committee Report*, p. 3051.

[14] The following figures appearing in the Report of the Director-General of Statistics shew the growth of the Capital, Reserve and Deposits of the principal Joint-Stock Banks registered in India:—

(In Lakhs of Rupees)

Year	Capital	Reserve	Deposits
1875	14	2	27
1880	13	3	63
1885	18	5	94
1890	33	17	270
1895	63	31	566
1900	82	45	807
1906	133	56	1155
1910	275	100	2565
1915	281	156	1787
1918	436	165	4059
1920	837	255	7114
1921	938	300	7689
1922	802	261	6163
1923	689	284	4442
1924	690	380	5250
1925	673	386	5449
1926	676	408	5968
1927	688	419	6084
1928	675	434	6285
1929	786	366	6272
1930	744	410	6321
1931	777	426	6223

into consideration the huge size of the country is significantly small. In the year 1919, 185 towns possessed a bank or branch ; by the year 1926 the number of such towns increased to 339. Still the number is very small knowing that India possesses as many as 2,300 towns. There is thus a very great scope and a still greater need for the growth of commercial banking. Not only that more banks should be started but the existing banks should extend the area of their operations by opening and extending branches. And wherever it may not be possible to open a full fledged branch the opening of sub-office or part-time branch in the first instance will lead to its growing into a branch later on.[15]

Causes of the Slow Growth of Commercial Banking

The causes which are responsible for the slow growth of joint-stock banking in India are various but some of the important ones may be discussed here.

Hoarding and Direct Loans

Hoarding and direct loans to trade and industry are both causes and effects of the slow growth of commercial banking in India. The dearth of banks in general and the absence of banks in many places is to a large extent responsible for these practices. But even where there are banks these practices exist, which is due either to the lack of knowledge of suitable investments by the people or their lack of confidence in the banks.

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[15] The following table gives the total number of Bank branches in India: —

	Head Office	Branches
Imperial Bank of India	3	165
Foreign Banks	–	88
Allahabad Bank	1	32
Indian Joint-Stock Banks	121	374
TOTAL ..	125	659

This gives to the Indian population a bank for every 440,000 people. Out of these, the branches of the foreign banks and the Allahabad Bank, which is controlled by foreigners, should not be considered a part of the Indian banking system. If we compare this with the number of banks in other countries we will realise the inadequacy of banking facility in this country. In England and Wales, there is a branch of a bank for every 45,000 of population. The following table gives the number of bank offices in some other countries :—

United States of America ..	25,000
Great Britain and Ireland ..	13,100
France ..	14,400
Germany ..	3,100
Belgium ..	1,200

Lack of Confidence

The lack of confidence in banks is to some extent due to the ignorance of the people and their conservatism but to a large extent it is due to frequent bank failures. In the past India has witnessed the largest bank failures and though at present bank failures have become less frequent they have not totally disappeared.

Attitude of Public Authorities

The attitude of the Government and action on the part of public authorities have seldom gone to encourage the development of joint-stock banking in this country. The care and custody of Municipal funds, funds of Courts of Wards, encumbered estates, minors' trust funds and university funds have never been entrusted to the joint-stock banks. The Indian joint-stock banks enjoy no privilege of any kind, no assistance from the State, and no preference. The State has the attitude of perfect *laissezfaire* towards them.

Opposition by Foreign Banks

The most important obstacle to the proper growth and development of Indian joint-stock banks has been the competition and opposition of foreign institutions. The foreign banks on account of their stronger position, earlier start and unrestricted business hold the most important and strategic points in the country. The most profitable business is monopolised by them and they do not tolerate the encroachment of Indian enterprize on their reserve.

With the advent of large-scale production and large-scale commerce "there is a feeling that a larger measure of trade and industry has passed out of control of Indians". Such businesses and even that which is in the hands of Indians are known in many cases to patronise foreign banks rather than the Indian joint-stock banks. "If foreign banks encourage foreign insurance companies and shipping compaines it stands to reason that these in their turn must encourage foreign banks. Indian firms, who are in their business obliged to deal, therefore, with non-Indian insurance companies, shipping companies, etc., would feel the pressure. Indian firms, who are in the position of brokers, agents, and who are in subordinate relation to European business houses and offices would not ordinarily have the courage, or the inclination, to deal with Indian banks."[16]

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[16] *The Central Banking Enquiry Committee, Part II, Minority Report*, p. 121.

Suggestions for Improvement—Progresssive Policy in Advancing Loans

Commercial banks in India should adopt a more progressive policy in advancing loans on the personal credit of the borrower and may, consistent with safety, advance loans for longer periods than they do now. These practices will both increase the field of their usefulness and make them more popular. Any risk which may be involved in the above practices will be minimised to a great extent if proper information about the customers could be available to banks. The banker's association as proposed by the Banking Enquiry Committee should be able to collect all such information and supply it to the member banks. Besides this the use of vernacular script in cheques, pass books and paying-in-slips will popularise the use of cheques and draw in many non-English-knowing customers.

Discounting Bills

At present the discounting of bills forms only a small part of the business of a commercial bank in India. In other countries the bulk of the resources of a commercial bank are utilised in discounting bills, which form its most preferable asset. It is, however, hoped that with the establishment of the Reserve Bank and the consequent provision of the rediscounting facility, the abolition of the stamp duty on bills of exchange and the development of the bill market in India, this part of the business of the commercial banks will develop considerably.

Remittance Operations

"One of the essential services which commercial banks are expected to render to the public is to transmit money from one centre to another quickly and economically."[17] As we have seen above this business to some extent is carried on by the Imperial Bank and the Indian joint-stock banks, but the rates charged by them are higher than are usually charged in other countries. The Banking Enquiry Committee have recommended a reduction in such charges with a view to a better utilisation of the resources of the country and a lowering of the rates of interest generally throughout the country. In the first instance they consider it desirable for the Imperial Bank to reduce the remittance cost and later on for the Reserve Bank to make transfers of money for member banks free of cost.

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[17] *Indian Central Banking Enquiry Committee Report*, p. 387.

State Aid and Concessions

But these alone will not solve the entire problem of the growth of joint-stock banking in this country. State aid and encouragement in the form of certain concessions to these banks and restrictions on the activities of the foreign banks to reduce their competition are very necessary needs which will make the existing banks earn high profits, which in turn will lead to the starting of more banks and will lead to a rapid and all-round development of joint-stock banking. In the light of this policy the joint-stock banks should be allowed the same remittance concessions which the co-operative banks enjoy at present, they should be afforded the same facilities for opening branches as were given to the Imperial Bank of India in the past and should have rediscounting facilities with the Reserve Bank and the benefit of special rediscount rate under the bank rate. The funds of various public and semi-public bodies should be allowed to be invested with the sound joint-stock banks. Definite restrictions should be imposed on the opening of branches in the interior by foreign banks. And restrictions should be imposed on making deposits by Indians and Indian joint-stock companies with the foreign banks.

World War II and Joint-Stock Banks

The enormous inflation of currency and the huge war expenditure of the Government of India and the Allied Governments, created a plethora of funds for which, except for Government contracts, there has been very little outlet in industrial investments. This naturally led to an increase of banking resources and banking activities in the country. Immediately on the outbreak of the war there was large-scale panicky withdrawal from banks, but this was a temporary phase and soon after confidence was restored and bank deposits began to increase fast. Consequently during the first five years of the war the number of joint-stock banks and their branches increased very much. In 1939 the number of scheduled banks was 57, in 1944 their number became 76. The total of the liabilities of the banks became three times in 1944–being Rs. 747·44 crores. It were the demand liabilities which increased, the time liabilities actually decreased. The proportion of demand liabilities increased from 56 to 75 per cent. while that of time liabilities fell from 44 to 25 per cent. The balances of these banks with the Reserve Bank also became three times between 1939 and 1944.

If the number of banks during this period increased by 19, the number of their branches increased by 864.

The number of offices of Scheduled Banks was 1,277 in 1939, while it was 2,141 in 1944. But this has only led to an over-crowding of banks in places where already joint-stock banks existed. Branches and offices were not started in places where banks already did not exist. They were multiplied in places already enjoying banking facilities.

Most of the new banks created during this period have not followed sound banking practices. The management in many cases is neither trained nor efficient nor free from connections with speculative ventures. The distribution of shares in some cases has been so manipulated as to give control to people who have subscribed only a small portion of the share capital. And the wide divergence between authorized, subscribed and paid-up capital in the case of these new banks makes their capital structure unsound.

Chapter XIV

SAVINGS BANKS

The Savings Banks in India are mostly Government organizations attached to the Post Offices. Recently some of the joint-stock banks have also opened savings bank departments. But the more important are the post office savings banks. Prior to 1896 there were district savings banks which were connected with the district treasuries. The business of the district savings banks was absorbed by a uniform system of post office savings banks in 1896. "From that date forward these savings banks have been managed by the Postal Department. No special reserve is maintained against these deposits. The deposit money constitutes what is known as the 'unfounded debt', and is a floating charge on the credit of the Government. The deposit money is utilised for capital expenditure. Although there may be a run on these banks the Government can meet it without any great difficulty.[1]

Working Days and Hours

All post offices that have savings banks are open to receive deposits daily with the exception of Sundays and other post office holidays. The hours for the transaction of business are from 10 A.M. to 3 P.M., and on Saturdays from 10 A.M. to 1 P.M.

At these banks any person—man, woman or child—may deposit money; and parents, other relatives and guardians may also deposit money on behalf of minors, that is, of persons who have not completed the age of 18 years.

Deposits

No sum less than four annas, and no sum that includes a fraction of an anna, can be received. No one is allowed to deposit more than Rs. 750 in each official year (1st April to 31st March) after deducting the amounts withdrawn during the year, or to have at any time more than Rs. 5,000 at his credit in cash (exclusive of interest), but a depositor can invest in an official year Rs. 5,000 in Government Securities. An account opened on behalf of a minor may never have more than Rs. 1,000 in cash (exclusive of interest); but the total amount at its credit may be raised by investments in Government Securities.

Government promises to repay the money, with interest, to the person depositing it in his or her name; but in the case of accounts opened on behalf of minors,

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[1] *Present-day Banking in India,* Rau.

Government will not repay this money during the minority of the minor to any one except his guardians.

Interest

Interest is allowed on sums of complete rupees at the rate of 3 per cent. per annum. It is calculated on the lowest balance at the credit of an account on any date between the close of the fourth day and the end of the month. The amount of interest is added to each account once a year after the 15th June.

Withdrawals

Money can be withdrawn only once a week and a sum less than four annas or any sum that includes a fraction of an anna cannot be withdrawn. When withdrawing money, the depositor should take or send his pass book with the withdrawal-form duly filled in. The payment of withdrawal at a Sub-office is subject to the condition that funds are available in the office. If funds are not available, they are obtained as soon as possible, and the depositor is told on what date to come for the money. At a branch office, payment cannot be made until an order of payment is received from the Head office or Sub-office to which the branch is subordinate.[2]

Not Very Popular

As is apparent from the nature of the business of the post office savings banks, their chief aim is to inculcate the habit of thrift amongst people whose savings are small. ".The majority of the depositors, however, belong to the professional classes and the intelligent middle class people. The labourer, the peasant and the artisan have yet to be drawn to the portals of the post office savings banks in increasing numbers."[3] "These savings banks attract the savings of the intelligent middle classes in towns, but investments in land on mortgage still appeal most strongly to these classes, and the farmer who happend to have spare funds declines as a rule to invest in anything else."[4] The post office savings banks, therefore, are not so popular in India, even amongst the middle class people, as they are elsewhere; and they are not at all popular amongst the rural population. In order to make them more popular "the Government of India should examine how far, notwithstanding the admitted administrative difficulties, it may be possible to improve the present procedure for the deposits and withdrawal of money and to increase the number of post offices conducting savings bank business."[5] The rate of interest—3%—offered by the savings banks is not attractive ; a higher rate should be offered in order to attract deposits. It is only fair that the Government may allow a higher rate of interest on savings bank deposits, when on its other loans it is paying a much higher rate. The maximum limit of Rs. 750 on yearly deposits and of Rs. 5,000 on aggregate deposits is too low. They should be raised, and depositors should be allowed to withdraw money more than once a week. In order to attract the poor classes and agriculturists ; to them, pass books should be issued in vernaculars.

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[2] *Vide* Post Office Savings Bank Rules.

[3] *Indian Central Banking Enquiry Committee Report,* p. 440.

[4] *Indian Finance and Banking,* Findley Shirras.

Suggestions for Improvements

The various Provincial Banking Enquiry Committees have also felt the necessity of introducing improvements in the working of the post office savings banks, and have suggested improvements in the following directions[6]:—

(1) Increasing the number of post offices.
(2) Increasing the number of post offices, where savings bank business could be done and Cash Certificates will be purchased.
(3) Facility for more frequent withdrawal.
(4) Facility for paying in cheques.
(5) Facility for withdrawing by cheques.
(6) Facility for transferring into one account in the savings bank, money from another account.
(7) The use of vernaculars in pass books and in signatures.
(8) The keeping of accounts in two names.
(9) Simplicity of forms.

Either on the above lines or on others which will go to make savings banks deposits more convenient and attractive to the Indian cultivator and artisan, improvements in the savings banks are only very necessary. The Indian cultivator and the artisan are poor and, at the same time, spendthrift. The inculcation of the habit of saving and thrift will depend to some extent on the facilities for them ; and these may be afforded by improving the present working and organization of the savings banks to the extent that it may be possible. "The scope for improvement is probably not very great and it is all the more reason, therefore, that it should be fully utilised."

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[5] *Sir H. B. Smith's Committee Report*, p. 32.
[6] *Indian Central Banking Enquiry Committee Report*, p. 353.

CHAPTER XV

THE EXCHANGE BANKS

Only Foreign Banks doing Foreign Exchange Business

OFFICIALLY an Exchange Bank is defined as one the head office of which is outside India. We have already seen that the Presidency Banks were not allowed to transact foreign exchange business, and the Imperial Bank of India was also restricted in taking up general foreign exchange business. The exchange banks thus have a monopoly in foreign exchange business in India. The number of such foreign banks in India is 18 and they have about 86 branches spread all over the country. Out of these 18 banks, 11 are branches or agencies of large banking corporations doing a major portion of their business abroad, while two, *viz.*, Messrs. Thomas Cook & Son (Bankers) and the American Express Company Incorporated, deal mostly with tourist traffic. The remaining five, *viz.*, the Chartered Bank of India, Australia and China, the National Bank of India, the Mercantile Bank of India, the P. & O. Banking Corporation and the Eastern Bank have a considerable portion of their business in India.[1]

The foreign exchange business or the financing of foreign trade consists of two operations, *viz.*, (1) the financing from the Indian port to the foreign port or *vice*

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[1] The following is a statement of the position of the various Exchange Banks carrying on business in India as at 31st December 1931 :—

Name	Capital	Reserve	Deposits	Cash and Investments
Bank of Taiwan Ltd. ..	772	138	15,094	16,176
Chartered Bank of India. Australia and China ..	3,000	3,000	43,632	26,079
Comptoir National D' Escompte de Paris ..	4,705	5,128	107,098	18,303
Eastern Bank, Ltd. ..	1,000	500	6,007	5,696
Honkong and Shanghai Banking Corporation ..	1,250	7,125	58,227	30,817
Imperial Bank of Persia ..	650	710	2.730	4,605
Lloyds Bank, Ltd. ..	15,810	8,000	382,102	241,245
Mercantile Bank of India. Ltd. ..	1,050	1,075	13,034	8,093
Mitsni Bank, Ltd. ..	3,529	3,164	40,997	22,693
National Bank of India, Ltd.	2,000	2,200	30,113	18.138
National City Bank of New York ..	37,200	22,800	389.813	255,880
Netherlands Trading Society	9,700	2,420	40,005	21,908
P. & O. Banking Corporation, Ltd. ..	2,594	180	7,017	9.371
Yokohama Specie Bank Ltd.	5,882	7,132	35,214	25,811

versa, and (2) the financing from, or to, the Indian port, to or from, the up-country distributing or collecting centres. "The bulk of this business, which consists mainly of dealing in foreign bills of exchange or foreign remittances, is in the hands of non-Indian banks, popularly known as exchange banks.[2]

Do Internal Business also

The exchange banks, however, do not confine their activities to foreign exchange business only. They conduct ordinary banking business also, and with the help of their 80 branches, compete against the Imperial Bank and other joint-stock banks in financing the internal trade of the country. Being banks incorporated in foreign countries, they are not governed by the Indian Companies Law and thus no statutory regulations are placed on their activities in India. "There is no provision, statutory or otherwise, which lays an obligation on these banks to furnish to any authority in India any figures relating to their business in India."[3] This makes their position much stronger in competing against Indian banks. Since they do not pay the taxes which Indian banks have to pay, they do not submit returns and publish statements of accounts and balance sheet, and are not required to keep a minimum cash balance, their lending power is greater and they are in a position to offer higher rates of interests on deposits.

(In thousands of £)[4]

Year	No. of Banks	Capital and Reserve	Deposits in Indin	Cash Balance in India
1913	12	37,825	23,276	4.411
1919	11	53 070	55,769	22,487
1920	15	90,217	56.105	18,881
1921	17	111,632	56,399	17,675
1922	18	112,221	55,038	12,132
1923	18	140,103	51,332	10.859
1924 ..	18	130,464	52.976	12,275
1925	18	138,311	52.909	7,062
1926	18	148,003	53,658	8.046
1927	18	180,919	51,647	6.098
1928	18	187,932	53,354	6,042
1929	18	227.625	49.994	6,789
1930	18	193,616	51,086	0,782

The above table, for example, indicates that though the capital and reserve of these banks have been steadily increasing their cash balances in India are decreasing so far so that in 1930, they had fallen to nearly one-fourth of what they amounted in 1919. Not only this, but comparing their cash balances to their deposits, it is evident that the position of their cash balances in India is very unsatisfactory indeed.

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[2] *Indian Central Banking Enquiry Committee Report*, p. 310.

[3] *Ibid.*, p. 311.

[4] *Statistical Tables relating to Banks in India for* 1930.

Methods of Business

The exchange banks, as we have already seen, have a monopoly in the financing of Indian foreign trade—both export and import. They finance the export trade by purchasing foreign bills negotiated in India and drawn on foreign debtors. These bills are sent to their foreign offices where they are either kept till maturity and then collected or, in case when these banks need funds, are discounted with the joint-stock banks or bill-brokers there. The import bills are negotiated in foreign countries and are drawn on Indian debtors (importers). These bills are purchased by the foreign offices of the exchange banks and are sent to them (exchange banks) in India, and are collected by them on maturity. But India is a creditor country and has generally a favourable balance of trade, *i.e.*, her exports are larger than her imports and the balance has to be paid to her. This balance is liquidated by the exchange banks by buying council bills and telegraphic transfers, by sending gold bullion, coin or silver bullion, by the transfer of Government rupee paper from London to India or by buying the sale of drafts needed by Indians abroad.

Deposits attracted in India

Till sometime back, the exchange banks carried on business with money borrowed in foreign countries principally in London, by attracting deposits there, by offering higher rates of interest than other joint-stock banks did. Within recent years, the banks have been able to attract deposits in India at equally favourable terms and a large amount of financing done by the exchange banks is carried through money borrowed here.[5]

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[5] No information is available as to how far each bank has secured deposits in India but the following statement published by the Director-General of Statistics in India indicates the rapid increase of the aggregate deposits within recent years.

(In lakhs of rupees)

1900	.. 1050	1919	.. 7435	1926	.. 7154
1905	.. 1704	1920	.. 7480	1927	.. 6886
1910	.. 2479	1921	.. 7519	1928	.. 7113
1915	.. 3354	1922	.. 7338	1929	.. 6663
1916	.. 3803	1923	.. 6844	1930	.. 6811
1917	.. 5337	1924	.. 7063	1931	.. 6746
1918	.. 6185	1925	.. 7053		

Their Strong Position and its Effects

The exchange banks are carrying on quite a lucrative business in India, their profits are high, and on account of their foreign incorporation and strong position, it is almost impossible to start an Indian exchange bank in the face of their competition. This means that on the one hand, Indian enterprize is excluded from this field and on the other, on account of their competition in ordinary banking business they adversely affect the Indian Banking development. Besides this, it has been noticed that the exchange banks do not mete out the same treatment and provide the same facilities to both Indian and foreign merchants. They show preference towards foreigners and provide them better facilities. Their attitude has even been hostile towards Indian firms and they have thus been a menace to the growth of Indian foreign trade. As Mr. Manu Subedar points out, " A general under-current of complaints pointing to distinct hostility by foreign banks towards Indian persons, Indian companies and Indian institutions generally, was noticeable. Indian jobbers in exchange were excluded, Indian brokers discouraged or boycotted, bills of lading of Indian steamship companies were tabooed, Indian banks were scoffed at and Indian effort, generally, either in trade or industry, was belittled. Such was the tale unfolded cumulatively out of what was said and what was left unsaid by Indian witnesses."[6]

As has already been seen, the strong position of the exchange banks is chiefly due to the fact that they are not subject to the same statutory restrictions which are imposed on Indian banks. Every country imposes some legal restrictions on the activities of foreign banks. In France and Spain, foreign banks have to pay higher taxes and are subject to more strict restrictions than the native banks. Even in England, which has such a powerful banking system, so much freedom in opening offices by foreign banks is not tolerated. There is no reason why the foreign banks in India should at least not be subject to the same rules and restrictions which the Indian banks are subject to. As Mr. Thakore is of opinion, the banking law of the country should apply to the foreign banks too and they should pay all those taxes which the Indian banks pay ; over and above these, they should be required to pay extra capital, loan and exchange taxes in the interest of affording protection to the country's banking enterprise.[7]

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[6] *Indian Central Banking Enquiry Minority Report*, p. 200.

[7] *Organization of Banking in India*, Thakore.

Suggestions of the Banking Enquiry Committee for Encouraging Indian Enterprises in this Field

The Indian Central Banking Enquiry Committee, after having recognised the necessity of Indians taking their proper share in financing India's foreign trade and the desirability of Indians not relying for all times on the facilities afforded by non-Indian institutions, recommend firstly the opening of foreign connections by well-established Indian joint-stock banks; and secondly, after the establishment of the Reserve Bank and the consequent withdrawal of the restrictions now imposed on the transaction of foreign exchange business by the Imperial Bank of India, the Imperial Bank to be induced to take up foreign exchange business. In this connection, they recommend that the Reserve Bank should enter into an agreement with the Imperial Bank for a period of five years to utilise the Imperial Bank as its agent wherever the former has not got a branch of its one and the latter has one; and to insist on a preponderance of the national element in the management and directorate of the Imperial Bank.[8] They further point out that in case a satisfactory agreement between the two is not arrived at, the Government should take steps to secure the establishment of an Indian Exchange Bank.

As a measure to counteract against the advantageous position which foreign banks have acquired in India, the Committee recommend that all non-Indian banks wishing to do banking business in India should be required to take out a license from the Reserve Bank. According to the conditions of this license, each non-Indian bank should be required to furnish to the Reserve Bank, annual statements showing their assets and libilities relating to the Indian business, to submit to the Reserve Bank, periodical reports of Indian and non-Indian business conducted by it and to submit to other conditions imposed on basis of reciprocity.[9]

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[8] (1) 75% of the Directors on Local Boards and a majority of those on the Central Board to be Indians. (2) No further recruitment of non-Indians on the staff of the Imperial Bank except in special cases and with the approval of the Finance Minister of the Government of India.

[9] There are various restrictions imposed by the law of foreign countries on non-national banks with a view to according reciprocal treatment to them, *e.g.*, the Bank of England grants no financial accommodation on the security of bills unless the bills bore two English names, of which one should be the accepter.

Other Suggestions for the Same

Six of the members of the above Committee not being satisfied with the recommendations of the Committee and considering the recommendations inadequate for putting an effective check on foreign domination in the field of foreign trade finance and the encroachment of exchange banks in the fields of finance for internal commerce, append a minute of dissent to the report and make their own separate recommendations. As the first step in this direction, they recommend that the State should start forthwith an Exchange Bank with a capital of three crores of rupees all to be taken up by the State. Such a bank, they recommend, should be started immediately without waiting for the establishment of the Reserve Bank, and should be entrusted with all the remittance business of the State. When the Reserve Bank is established the exchange bank will become the agent of the Reserve Bank in remittance business, as it will then be taken up by the Reserve Bank. The State Exchange Bank will do the financing of export and import trade like any exchange bank and for this purpose will receive deposits, and lend money on produce awaiting exports or imports awaiting distribution. It will be governed by Central and Local Boards consisting of 7 and 5 members respectively and nominated by the Government, and the staff of the bank as far as possible will be Indian.

Advantages of Creating a State Exchange Bank

The authors of the above suggestion claim two special advantages for it. Firstly, that such a State bank being under State control could be easily checked in its attempts to encroach upon the business of the Indian joint-stock banks. "It is very necessary to do this in a scrupulous manner and not to leave scope for any further harassment in the activities of Indian joint-stock banks." Secondly, that a State Exchange Bank will be a suitable institution to handle the enormous liabilities of the Government of India for remittance abroad to meet the foreign obligations of the country. The amount of annual remittances abroad on account of the Government (40 crores) and private persons averages to about 80 crores of rupees. This high figure of remittances alone necessitates the starting of a separate institution to carry out the work efficiently and cheaply and particularly so when it has been observed that the exchange banks in India have not always helped the Government in this business.

Exchange Banks not to do Business in Up-Country Towns

As regards the encroachment of exchange banks on the business of the Indian joint-stock banks they recommend that in future, no exchange bank should be allowed to open a branch in any up-country town, *i.e.,* at no other place than at Calcutta, Bombay, Madras, Karachi and Rangoon. They are also opposed to granting licenses to non-Indian banks for opening branches in the up-country.

Further Suggestions for Restrictions on Foreign Banks

Mr. Manu Subedar, one of the members of the Central Banking Committee, wants, however, to go further in the matter of imposing restrictions on foreign banks. He is of opinion that the terms of license of foreign banks would have to be materially different from those governing the Indian banks. "The object of making any terms at all is to protect different classes of Indian public and Indian institutions from unsound foreign bank, from foreign banks now operating which may become unsound in course of time, from malpractices, unfair competition, anti-social and anti-national activities, which they may indulge in with reference to the Indian public or Indian banks." From this point of view he suggests the inclusion of the following various terms in the license given to foreign banks:—

1. The licensed bank should not receive deposits in India from Indian-born persons or joint-stock companies registered in India.

2. The licensed bank shall confine its branches to the port areas only, and no branch shall be opened in the interior.

3. Controlling interests directly or indirectly shall not be acquired in an Indian institution in order to defeat the above provision, or for any other motive.

4. The existing branches in the interior should be withdrawn *pro-rata* within five years, and the banks concerned should submit forthwith a programme indicating the manner and extent to which they will be withdrawn during each of these five years.

5. It shall not be opened to the licensee to engage in trustee business in this country, which would put Indian funds in their hands.

6. Except the manager and one official in each branch under him, the whole staff shall be Indian.

7. The licensed bank shall pay full income-tax on its earnings in this country and disclose all accounts and particulars to enable the revenue authorities to frame the demand.

8. The assets of the licensed bank in the event of liquidation should be liable to be taken possession of by the Official Receiver of High Courts in India, and the license is

issued on the basis that the licensee agrees that Indian creditors will have a full prior right on such assets.

9. Copies of all statistical returns, reports, papers, and balance sheets, prepared in connection with the business of the Indian branches supplied to their head offices, would have to be lodged with the licensing authority in India.

10. All information relating to business done in this country in the form in which it is desired by the licensing authority, would have to be given by the bank. The licensing authority will have absolute discretion, as to which of this information should be published.

11. The licensing authority will determine whether and which branches of the licensee bank will be admitted to the Clearing House.

12. The licensing authority will also determine whether and which branch of the licensee bank will be eligible for re-discounting or any other facilities from the Reserve Bank.

13. The licensee bank undertakes that its officials shall not participate in any anti-national movement in India, or assist such movement with funds or in any manner.

14. That it shall not in combination of other banks or persons, make a ring or pool, or a combination, or working arrangement without the express permission of the licensing authority, who will see that such action on their part does not harm interests.

15. That it shall not combine with other banks, Indian or foreign, to make business rules, or impose charges payable by the Indian clients, which shall not have been approved of by the licensing authority.

16. The licensed bank undertakes to conform to the laws of India in all disputes, which may arise between it and any Indian-born person or company registered in this country and that neither the bank nor any of its officials will claim any special privilege in contravention of such laws."[10]

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[10] *Indian Central Banking Enquiry Committee, Part II, Minority Reports*, p. 201.

CHAPTER XVI

INDUSTRIAL BANKS

Present Position

THE first Industrial Bank started in India was the Tata Industrial Bank, which was established in 1918, and was merged in the Central Bank of India in 1923. The Tata Bank was the poineer in the direction of Industrial Banking. In its wake came several other industrial banks, *e.g.*, The Industrial Bank of Western India, The Surat Industrial Bank, The Karani Industrial Bank, The Indian Industrial Bank, The Simla Banking and Industrial Co., etc.[1] Besides these in some native states also industrial banks have been started. But industrial banking as yet is not even in its infancy in India. Not only the number of these banks is very small but the usefulness of their business is even more limited. They are unco-ordinated units which are little better than mere machineries for raising capital. The Tata Industrial Bank was the only industrial bank worth the name and that too amalgamated with the Central Bank of India. Thus the present banking organization in India is exclusively a system of commercial banking. The commercial banks cannot take up the financing of industries. Not only will it be dangerous for them, but they do not know much about industries and industrial affairs. They can certainly go on supplying working capital, but the financial part of the business which deals with the establishment or extension of the factory or the industry can only be dealt with by a properly organized industrial banking system.

Need for Industrial Banking

It is a pity that a country like India with such potentialities for industrial development should be industrially backward simply because of the non-existence of industrial banking. But it is a hard fact that the most important factor for the development of industries is the systematic supply of industrial credit. And this can only be possible through development and organization of industrial bank-the India's banking needs are like those of Germany and Japan after 1860 ; and these two countries owe their economic development to the growth of industrial banking.

Commercial Banks take up Industrial Finance

In the absence of industrial banks in India, the commercial banks take up some of the work of industrial finance. This means a double loss : on the one hand a danger to the stability of such banks, and on the other the starvation of the genuine and growing commercial needs of the country to this extent. The financing of the needs of long-term credit to industries and the provision of initial capital for their flotation is at present in the hands of the managing agents.

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[1] *Journal of Indian Industries and Labour*, February 1921.

Evils of the Managing Agency System

The managing agency system has been and is an evil to industrial development. It not only absorbs too large a share of profits but also interferes with the flow of capital into industry. Managing Agents have contracts with provision not only for long periods but for their perpetual renewal, and often the managing agents could not be got rid of, except when they resign. Some of the contracts involve payments to the managing agents whether the company makes a profit or not.... The managing agency system thus absorbs too large a share of the profits and makes industry as a whole less attractive to the investor. It therefore tends not to encourage but to check the flow of capital in industry.[2]

Needs of Small and Big Industries

The need in India for finance is not only for big modern industries, but is even more so for small cottage industries. The system of industrial banking must be organized therefore to meet both these forms of industrial development. The need of the artisan is not for big sums, but is for small sums which he may be able to get at the right time at a low rate of interest. This need cannot be met by the big industrial banks; it will neither be possible nor profitable for them to advance small sums to scattered individuals. For this purpose the best remedy can be the establishment of co-operative industrial credit unions on the lines of artisan's credit societies. The industrial banks can exercise a controlling influence on these unions, by advancing money to them and subjecting them to their supervision and control.

Industrial Banks

The industrial bank should be a much bigger affair, able to meet the demand of large-scale industries. Such banks should receive deposits for long terms or issue their own bonds or debentures, and these along with their capital can be utilised for supplying long-term industrial finance.

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[2] *Indian Central Banking Enquiry Committee, Minority Report*, p. 331.

Besides their own advances they should underwrite or purchase a part of the share capital of new prospective concerns. The arrangement of foreign loans to industrial concerns is one of the most important functions of an industrial bank. The industrial banks can more easily raise credit in foreign markets on their guarantee, than industrial concerns independently can do.

State Aid

For being able to perform these functions successfully the industrial banks should possess large capital and sound reputation. For both these State-aid is very necessary. The State should, as in other countries, subscribe a portion of their share capital or guarantee dividend on their share capital and lend State credit to them whenever necessary, and also exercise a control over their activities by placing its nominees on their boards of directorate. The industrial banks have to engage a staff of financing experts to investigate into and analyse the potentialities and *bonafide* of industrial ventures. Such experts are generally highly paid men. In the case of India, in order to minimise expense a common staff of financial experts partly supported by the Government is more suitable. As in industries so in industrial banks a policy of co-ordination is necessary. Our industrial banking organization should therefore be a co-ordinated one. In the words of the Bombay Industrial Advisory Committee, "the establishment of a Central Industrial Bank or similar organization with a large capital and numerous branches designed to afford financial support to industries for longer periods and on less restricted security than is within the power and practice of the existing banks is urgently needed as in the case of Japan, a certain amount of Government aid and Government control are also necessary for its safe working."

Provincial Industrial Banks

The Indian Central Banking Enquiry Committee of 1930 also recognised the very great need for the creation of industrial banks for supplying long-term credit to Indian industries. They recommend the establishment of provincial industrial banks in provinces where the provincial governments may find it necessary to ensure the supply of financial facilities to industrial concerns. Such industrial corporations, they say, should specialise in the provision of long-term capital to industry while working capital may be obtained from the existing institutions. The corporations should obtain their working capital from the public, and the Government should contribute only that portion which cannot be raised by public subscription. The corporations should accept long-term deposits only and raise more funds by the issue of debentures.

All-India Industrial Bank

Mr. Manu Subedar, one of the members of the Committee, in his minority report further emphasises the need of the creation of special institutions for financing Indian industries. He, therefore, recommends the establishment, without delay, of an All-India Industrial Bank with branches, for the present, at Calcutta, Bombay, Madras, Lahore and Cawnpore. Such a Central Industrial Bank should be started with a capital of Rs. 5 crores and for some years the Government should hold not less than 50% of its capital. The Bank should be allowed to issue bonds to any extent, which should have the guarantee of the Government and should be included in the list of Trustee Securities. The guarantee of the Government, he points out, would enable larger funds to be raised at a lower rate. The Industrial Bank may receive deposits at its various branches, without any restriction, may advance finance to industries both for long and short terms: from periods ranging from one to ten years. The bank before giving the loan will make careful enquiries into the purposes of such loans and in the prospects of the industry. It will help industries to make extensions and replace old capital, and will advance money as working capital. The Industrial Bank besides providing financial facilities would help its clients in other directions also on the agency basis. It will have power to underwrite the debentures of industrial concerns and take up their sale in the market, or purchase them temporarily. It wil give advice to promoters of new concerns and may also take up a part of the preferential capital of such concerns.

CHAPTER XVII

LAND MORTGAGE BANKS

Need for Agricultural Development

INDIA is predominantly an agricultural country; agriculture is her chief industry on which more than 70% of her people depend. It is a foregone conclusion, therefore, that the prosperity of the country depends upon the prosperity of her agriculture. No amount of commercial and industrial development can make the country prosperous if her agriculture is backward. And unfortunately Indian agriculture is the most backward in the world to-day. One of the very important causes of this backwardness is the scarcity and disorganized nature of agricultural capital. The amelioration of the Indian cultivator lies in the adoption of some sort of intensive cultivation. "Intensive cultivation is however, as a rule, possible where capital has been invested in the improvement of land or in providing it with irrigation."[1] The crux of the whole problem of agricultural improvement, therefore, is finance.

Two Classes of Agricultural Finance

Agricultural finance can be divided into two classes: Long-term finance and short-term finance. The former term indicates the supply to the cultivator of money and credit for long terms in order to carry on permanent improvements such as the construction of wells, tanks, works for the drainage of land and for protection of land from floods, purchase of cattle and erection of buildings. The latter indicates finance for current requirements such as the purchase of seeds, fertilisers, feeding stuff, etc.

Local Money-lender the Chief Financing Agency

At present the greater proportion of the funds required by the Indian cultivator both for agricultural purposes and for domestic and ceremonial expense is provided by the local money-lender. The regime of the money-lender is said to be the most defective imaginable. Any proposal for the financial stability of our agricultural system, therefore, must involve the replacement of the money-lender by an organized system of credit.

Co-operative Credit Societies

In the direction of providing short-term credit a beginning has been made by the establishment of the village co-operative credit societies, and though they are yet in their infancy, and are making a slow progress in time to come it is hoped that they will be able to replace the evil system of the money-lender. But these credit societies with their slender resources and special constitution cannot provide long-term finance. For this purpose there is the necessity of big institutions with large capital able to supply credit for long periods and in big amounts.

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[1] *Royal Commission on Agriculture in India Report,* p. 491.

Present Position

"For the solution of the problems arising from the demand for large loans for long terms, attention has naturally been directed to the land mortgage banks of Germany and, in some provinces, the question of introducing institutions on this model has received careful study. The first experiment took shape in the Punjab in the Jhang Co-operative Land Mortgage Bank, Ltd., and altogether there are now a dozen organizations of this type in that province while Madras has fifteen, of which however, only three are doing real work."[2] It is however clear that it is only to an insignificant extent that a step has been taken in this direction. Since village societies cannot take up the work of long-term credit, some institution should be created which will be able to advance money for long terms, repayable at least after 25 or 30 years and which will be equipped with management possessing business capacity and expert knowledge required to investigate titles, evaluate lands, assess the worth of the credit of the borrower and so forth. Such institutions can be the Land Mortgage Banks.

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[2] *Royal Commission on Indian Agriculture in India Report,* p. 461.

The number of Land Mortgage Banks in India at the present time is as follows :—

Province		No. of Banks	
Punjab	..	.. 12	Two of these operate over whole districts, the rest confine their operations to a single tehsil
Bombay	..	.. 3	
Bengal	..	.. 2	
Assam	..	.. 5	
Madras	..	.. 38	Primary land mortgage banks and a central land mortgage bank have been started recently.

Among the objects for which these banks advance loans are the redemption of old debts, improvement of land and method of cultivation and the purchase of land in special cases. Nothing, however, can be said at this early stage about the success or otherwise of these banks.

Functions

The functions of the mortgage banks as described in the bye-laws of the Co-operative Mortgage Bank, Limited, in Bengal are the following :—

(1) The redemption of mortgages and liquidation of old debts.

(2) The improvement of land and method of cultivation.

(3) Installation and purchase of agricultural machinery.

(4) The purchase of land.

(5) The grant of cash credit advances for current requirements of members.

It will be evident from the above that the functions of a land mortgage bank need not be confined to the provision of strictly long-term credit. Since a land bank especially in India, cannot usefully confine itself solely to the provision of long-term credit, the question has been raised whether it would be worth while from the point of view of cost and other considerations to start a separate land mortgage institution or to make it a link or a special department of the Central Bank (Reserve Bank). The Agricultural Commission think that there is scope for the establishment of Co-operative Mortgage Banks, obviosuly as separate institutions.

All-India Co-operative Bank

In the words of Mr. Collins, "What agriculture requires is access to the money market and to Government funds on the same terms as commerce and industry." The problem will be solved, therefore, by the formation of an All-India Co-operative Bank with somewhat the same relations with the Government as the Imperial Bank of India now has. And further, the State may guarantee or itself purchase the mortgage debentures of the bank and thus help it at least in the initial stages. According to the Agricultural Commission's view, the State should not purchase debentures, but if there is need for funds, the bank can take charge of loans under the Land Improvement Loans Act. This shall, however, not be sufficient; a simple provision like this is not calculated to inspire confidence. There are two essentials regarding the floating of mortgage debentures : firstly, the community should be educated in the principles of land mortgage banking ; and secondly, there must be a centralised organization regarding the issue of the mortgage debentures. Finally, these debentures should be registered under the Co-operative

Societies Act and be included in the list of securities given in Section 20 of the Indian Trust Act, 1882.

Such a Central organization with its branches in various parts of the country will, it is hoped, be adequately able to meet the need of long-term credit for Indian agriculture.

Commercial and Co-operative Land Mortgage Banks

The Indian Central Banking Enquiry Committee recommend the establishment of two kinds of land mortgage banks for India: The Commercial Land Mortgage Banks on joint-stock basis and the Co-operative Land Mortgage Banks of the Prussian type. "The Commercial Land Mortgage Banks may, perhaps, be better suited to finance big landlords or zamindars. So far as relief to small agriculturists and owners of small holdings is concerned, the co-operative type is the most suitable."

Initiative by Provincial Governments

The Committee recommend the development of Joint-Stock Commercial Land Mortgage Banks in various parts of the country to provide finances to big landlords for long periods for expensive and permanent improvements in land. They think that the Provincial Governments should take the initiative for the establishment of such banks and provide a portion of the initial capital. The banks should derive their working capital from both shares and debentures. The Provincial Governments may guarantee the interest on the debentures and the same may be included among trustee securities.

Co-operative Banks

The co-operative type is best illustrated by the Prussian Farm Mortgage Mutual Credit Associations. The Prussian banks do not possess any capital, nor do they aim at profit. The expenses of the bank are met from the entrance fee paid by each member, and credit is created by creating mortgage bonds bearing interest. Such co-operative land mortgage banks are considered to be most suitable for financing the small holders who cannot secure credit except through organizations based on mutual association and guarantee. "The funds of such a bank can best be raised only on the collective guarantee of the properties mortgaged by the members. It follows that the members who thus create credit should have a voice in the management of their bank on well-organized principles of democratically controlled co-operative institutions."[3]

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[2] *Indian Central Banking Enquiry Committee Report,* p. 155.

Loan

The Committee recommend that the loans by these land mortgage banks should be devoted to the redemption of land and houses of agriculturists, liquidation of old debts, improvement of land and methods of cultivation, the building of houses and the purchase of land. The loans should be advanced for stated period of five, ten, fifteen or twenty years and the amount of individual loans should not exceed Rs. 5,000. The repayment of loans should be by a system of equated payments, thereby amortising the loan at the end of a period of years.

Working Capital

The working capital of such banks should be derived from share capital and debentures. A part of the share capital may be obtained by initial subscription by the intending members, and the rest by deducting a certain percentage of the amount borrowed by the members at the time of advancing the loan and by the advance of the Provincial Governments wherever necessary. The larger part of the working capital should, however, be raised by means of debentures. The interest on debentures should be guaranteed by the Government and they should be included among trustee securities. Such debentures should be issued by the Provincial Land Mortgage Corporation, while their sale may be effected by both provincial bank and the primary or district land mortgage banks.

CHAPTER XVIII

CO-OPERATIVE MOVEMENT

Agricultural Finance

WE have already said in the previous chapter that agricultural finance is of two kinds—finance for long term, and finance for short term. There is the need for permanent improvements in agriculture and there is the need of the small cultivator for working capital and for replacements and renewals. The Land Mortgage Banks cannot meet this need of the small cultivator, nor can it be met by any other big organized institution run for earning profits. The fact that the cultivators are scattered over a large area, they want small sums, are not punctual in payment and have worthless securities to offer makes the business of financing too difficult and unprofitable for big institutions who may want to do business on a large scale. Thus the local money-lender, who is satisfied with a small amount of business because he generally carries on some other business and who, since he belongs to the place, has the advantage of personal knowledge and can utilise the possessions of the cultivators in the event of default, is the chief agency which has this buisness in its hands. But the financing done by the money-lender in most cases does more harm than good to the cultivator. The money-lender charges exorbitant rates of interest, keeps accounts fraudulently, advances loans for unproductive purposes and adopts many other evil practices which all result in worsening the economic position of the cultivator and are one of the most important causes of his permanent indebtedness. The regime of the village money-lender is the most defective imaginable and in the interest of the amelioration of the lot of the ryot and in the interest of agricultural development, it is necessary that he may be replaced by an agency which may be able to finance the cultivator for his economic betterment.

Needs and State of Small Artisans

Whatever is true of the state of financing the small cultivator, the same is true of the small artisan. He also cannot get finance from organized banks and has thus to depend upon the small money-lenders in towns or villages. The condition of the small artisans, therefore, is as bad as that of the cultivators and that is also mainly due to the absence of adequate and proper financing facilities.

Co-operation

1 If, therefore, no organized outside agency can take up the work of financing the poor cultivator and the petty artisan, and if the agency which can and does this work—the money-lender—is doing more harm than good, the only 2 hope for these people lies in self-help. The other name of self-help is co-operation. "Co-operation is a form of organization, wherein persons voluntarily associate together as human beings on a basis of equality for the promotion of the economic interests of themselves."[1] The theory of co-3 operation is very briefly that an isolated and powerless individual can, by association with others and by moral development and mutual support, obtain, in his own degree, the material advantages available to wealthy or powerful persons, and thereby develop himself to the fullest extent of his natural abilities. By the union of forces 4 material advancement is secured, and by united action self-reliance is fostered, and it is from the interaction of these influences that it is hoped to attain the effective realisation of the higher and more prosperous standard of life which has been characterized as 'better business, better farming and better living'."[2] Thus co-operation does not merely stand for the betterment of the economic condition of the people ; it goes farther and is equally, or rather more, effective in the moral development and education of the people.

Co-operation in Germany

The condition of agriculturists and artisans in Germany in the middle of the nineteenth century was as bad as their condition in India to-day. This made a strong impression upon two public-spirited men who were contemporaries of each other. One of them, Schulze-Delitsch, organized credit societies to help the petty traders and artisans. The other, Raiffeisen, who was a burgomaster in Prussia, organized credit and other societies for the poor agriculturists. In the beginning these efforts encountered Government opposition and the progress was slow. But after some time, these difficulties being overcome, the movement achieved brilliant success and Germany became the pioneer in the movement. Co-operation worked miracles in the case of the poor agriculturists and artisans of Germany. It lifted them out of poverty and ignorance and placed them on a footing of prosperity and dignity.

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[1] *The Law and Principles of Co-operation*, p. 13, Herbert Calvert.

[2] "Maclagan Committee Report", Part 2.

Features of Raiffeisen Societies

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Since it is the German types of credit societies which have been imitated in India, it will not be out of place to study the main features of each of them. In the case of the Raiffeisen society the chief requisites are the following :—(1) joint and unlimited liability of members ; (2) a closely restricted area of operation ; (3) no shares, or very low shares to enable the poorest persons to become members ; (4) loans mainly for productive purposes ; (5) gratuitous service on the managing committee ; (6) limitation of loans to members and reliance on personal rather than real credit ; (7) allocation of profits to an indivisible reserve ; and (8) promotion of moral as well as material advancement of members.

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Schulze-Delitsch

The Schulze-Delitsch type has the following main features which differentiate it from the Raiffeisen type :—

(1) Limited liability ; (2) wider area of operation ; (3) greater importance of share capital; (4) freer distribution of profits ; (5) paid administration ; and (6) greater emphasis laid on the business aspect rather than on the moral results.

Act of 1904

The success of co-operative societies in Germany towards the close of the last century led to their introduction in other countries, and in 1904, with the passing of the Co-operative Credit Societies Act, co-operation was launched in this country also. The Act, however, applied to credit co-operation only. Since there was no previous experience of the movement in India it was wise to select one line only. This legislation was not the result of popular demand but like that in Japan it was the outcome of the desire of the Government to better the lot of the ryot. And in the face of this the creation of a Government department in charge of the movement was necessary. The main provisions of the Act of 1904 were the following :—

(1) Any association of ten major persons belonging to the same village, tribe, caste or town could apply for registration and form a co-operative society.

(2) The societies were to be rural according as four-fifth of their members were agriculturists or not.

(3) Rural Societies were to have unlimited liability, while the matter was left to their choice in the case of urban societies.

(4) The profits of a rural society were to be created to an unalienable reserve fund.

(5) The size of the share capital was to be limited, and no member could hold more than one-fifth of the shares but the total value of the shares held by a member could not increase Rs. 4,000 nor could he have more than one vote.

(6) The required working capital was to be raised by the societies by entrance fees, shares, deposits from members and loans from outside and the funds so raised could be distributed among members only.

(7) Registrars of co-operative societies were to be appointed in all provinces for supervising the movement and to control it.

(8) The powers of compulsory inspection, audit, dissolution, etc., were reserved by the Government for themselves.

Government Sympathy

We have already said that the movement in this country was started by the Government, who having no co-operative experience to guide it had to depend entirely upon the official staff to carry out its policy but this at least assured the movement of Government sympathy and assistance. Thus to encourage the movement, Government offered certain concessions and privileges to the societies registered under the Act, such as exemption of income-tax, stamp duties, registration fees, priority to ordinary creditors of a member, free audit, etc.

Act of 1912

The Act of 1904 provided only for credit societies ; it did not make any provision for non-credit societies neither it gave any protection to the central agencies, bank and unions which were now coming into existence to finance the primary societies. They had still to be registered under the Indian Companies Act. These deficiencies were remedied by Co-operative Societies Act (II of 1912), which, besides other things, provided that not only credit societies but any society may be registered "which has for its object the promotion of the economic interests of its members in accordance with co-operative principles, or a society established with the object of facilitating the operations of such a society ;" that the liability of central societies was to be limited while that of rural credit societies to be unlimited ; that any credit society, with the Registrar's sanction, after carrying one-fourth of the annual net profits to a reserve fund, could contribute upto ten per cent. of the remaining net profits to charitable purposes; that 'Co-operation' may not be used as the title of any business concern not registered under the Act; and that shares or interest in co-operative societies were exempt from attachment. Thus the Act of 1912 "recognized non-credit forms of co-operation affecting purchase, sale, production, insurance, housing, etc. It also recognized three kinds of central societies as distinguished from primary societies, namely, (1) Unions, consisting of primary societies for mutual control and audit; (2) Central Banks, consisting partly of societies and partly of individuals and (3) Provincial Banks, consisting of individuals."[3]

Primary[4] Societies—Agricultural

Thus at the present ~~day~~ there exist in India Primary Societies, both agricultural and non-agricultural, and Central and Provincial Co-operative Banks. Primary Agricultural Credit Societies form the basis of Credit Co-operation. Any ten or more persons can apply for registration of a credit society but the maximum strengh of the society should preferably not exceed one hundred because a larger number may mean lesser efficiency of management and supervision. Their area is usually restricted to a village in order to ensure mutual knowledge and mutual control on the part of members, but exceptions to this rule in favour of certain tribes and communities are however allowed. The liability of such societies is mainly unlimited. Unlimited liability has an educating influence on the members by making mutual control and supervision necessary and it improves the credit of the societies. The management of the societies is democratic and honorary and is in the hands of a general committee consisting of all the members and a managing committee which consists of five to nine members chosen from amongst the mem-

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[3] *Indian Economics*, Jathar and Beri, Vol. I. p. 293.

[4] The financial position of primary agricultural societies on the 30th of June 1932 stood thus:—

	In thousands of rupees
Share Capital	4,38,98
Reserve Fund	7,20,08
Deposits	3,22,81
Loans	20,03,35
Total Working Capital	35,09,25

bers of the general committee. The working capital of the societies is raised from entrance fees, share capital, deposits or loans from non-members, loans from Central and Provincial Banks, loans from Government and the reserve fund. Loans are given to members for short, intermediate and long periods. Short-term and intermediate loans are given for purposes like, buying of cattle and implements ; purchase of manure and seeds ; maintenance of the farmer and his family ; payment of revenue and rent; outlay of various kinds of improvements effected in the ordinary course of agriculture such as levelling, drainage, clearance, etc. While long-term loans are advanced for the purchase of land, acquisition of costly equipments, consolidation and improvement of holdings and repayment of past debts.

Non-Agricultural Credit Societies

These are mainly modelled on the Luzzati type in Italy and Schulze-Delitsch type in Germany. Amongst them are peoples' bank meant chiefly for the middle class people; commercial societies for helping the members of a particular community ; and Artisans' Societies. Artisans' Societies are like Agricultural Credit Societies in their constitution and business, except that in their case unlimited liability is optional.

Central Banks[5]

After the passing of the Co-operative Societies Act of 1912 the formation of banks in urban areas on co-operative principles became possible. The functions of the central banks or central societies are to supply the required capital to the primary societies, to make the surplus resources of some societies available for other societies and to provide proper guidance and inspection over them. The management of such banks is usually local and their operations are generally confined to a small area. The main sources from which they derive their working capital are share capital, reserve, deposits and loans. They advance loans to primary societies for periods for which they receive deposits and to the extent of the estimated value of the assets of the society. The profits of central banks are distributed as allocations to reserves and dividents to shareholders.

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[5]

	Crores of rupees
Capital in 1931–32	30·6
Deposits held in 1931–32—	
from individuals and other sources ..	18·5
from Primary Societies	2·7
Total advances to Societies	8·0

Provincial[6] Co-operative Banks

Except in the United Provinces there are provincial co-operative banks in all the major provinces. The functions of these banks are more or less the same in all provinces. They co-ordinate the work of the central banks and act as the balancing centre of the various central banks in the province. They get their working capital by receiving deposits from the affiliated co-operative societies and from the public. The period for which they advance loans is determined by the period for which deposits are accepted. In every province these banks have fixed a maximum term beyond which no loans are sanctioned to the borrowing client. These banks also carry on ordinary banking business, such as collecting hundis and dividends from companies and collecting the pay and pensions of public servants. Some of these banks have floated long-term debentures, which are recognized as a trustee security. There is an All-India Provincial Co-operative Banks' Association, which enables the member bank to ascertain which bank has a surplus of funds and which a shortage. These are adjusted by receiving deposits from surplusing banks.

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[6] PROVINCIAL BANKS, 1931-32

In thousands of rupees

Working Capital :	
Share Capital	66,99
Reserve and other funds	49,94
Deposits and Loans :	
from individuals	4,81,97
from Provincial and Central Banks	3,24,30
from Societies	49,22
from Government	18,60
TOTAL	9,89,02
Loans made during the year to :	
Individuals	3,28,11
Banks and Societies	2,62,94
TOTAL	5,91,05
Loans due by :	
Individuals	6.02
Banks and Societies	4,80,19
TOTAL	4,86,21

Progress Made by the Movement

The following table[7] shows the amount of progress made by the movement during recent years.

Agricultural Co-operative Societies

Year	Credit			Non-Credit		
	No. of Societies	No. of Members	Working Capital (Rs. in Lakhs)	No. of Societies	No. of Members	Working Capital (Rs. in Lakhs)
1915–16 ..	16,690	665,527	4,92	96	4,822	1
1916–17 ..	19,463	723,329	5,65	160	7,186	1
1917–18 ..	21,688	767,265	6,36	249	13,944	5
1918–19 ..	26,214	864,500	7.34	437	24,237	13
1919–20 ..	32,595	1,046.839	8.73	616	34,057	18
1920–21 ..	37,673	1,204,199	10,60	857	50,212	21
1921–22 ..	41,516	1,347,277	12,08	1,073	62,984	30
1922–23 ..	45,043	1,442,080	13,47	1,196	57,320	32
1923–24 ..	49,118	1,585,708	15,15	1,595	77,686	40
1924–25 ..	54,390	1,749.186	17,59	1,769	99,694	49
1925–26 ..	59,018	1,901,529	20,47	2,133	121,789	54
1926–27 ..	65,101	2,115,746	24,14	..	154,322	58

The following table shows the extent to which the rural population in different provinces has been touched by the movement.[8]

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[7] *Report of the Royal Commission on Agriculture in India*, p. 446.

[8] *Ibid.*, p. 447.

Province	No of members in all agricultural societies in 1926–27	No. of members *in* agricultural credtt societies in 1926–27	Rural population in 1921 in 000's	No. of rural families in 000's	Proportion of members of agricultural societies to families in rural areas	
					All societies per cent.	Credit societies per cent.
Ajmer—Merwara	10,185	9,879	330	66	15·4	15·0
Assam	42,478	42,478	7,428	1,486	2·9	2·9
Bengal	380.562	329,765	43,509	8,702	4·4	3·8
Bihar and Orissa	205,825	205,000	32,627	6,525	3·2	3·1
Bombay	300,077	260,182	14,908	2,981	10·0	8·7
Burma	93,161	87,447	11,921	2,384	3·9	3·7
C.P. and Berar ..	59,459	58,039	12,519	2,504	2·4	2·3
Coorg	11,223	11,223	155	31	36·2	36·2
Delhi	42,50	4,250	184	37	11·5	11·5
Madras	612.220	583,315	37,040	7,408	8·3	7·9
N.W.F.P.	681	618	1,915	383	0·2	0·2
Punjab	401.542	373,155	18,473	3,694	10·9	..
United Provinces	148,405	148,332	40,570	8,114	1·8	1·8

The above table shows that except in the Punjab, Bombay and Madras, the movement in other provinces has made very little progress and has so far reached only a small part of the rural population.

Results Achieved

"The main results achieved may be said to be the provision of a large amount of capital at reasonable rates of interest and the organization of a system of rural credit which, carefully fostered, may yet relieve the cultivator of that burden of usury which he has borne so patiently throughout the ages. Knowledge of the co-operative system is now widespread, thrift is being encouraged; training in the handling of money and in elementary banking principles is being given. Where the co-operative movement is strongly established, there has been a general lowering of the rate of interest charged by money-lenders; the hold of the money-lender has been loosened, with the result that a marked change has been brought about in the outlook of the people."

Progress Very Slow

In spite of whatever has already been achieved by the movement, it must be admitted that 'all that has been done amounts only to a scratching of the surface'. Co-operation is still in its infancy in this country. In spite of its existence for 32 years it has not been able to remove the indebtedness of the agriculturists or the artisans nor has it been able to replace or remedy the pernicious system of the small money-lender. The economic position of the cultivator and the artisan is in the main as bad as it was before the starting of the movement. No doubt some thing appreciable has been achieved in the provinces of the Punjab, Bombay and Madras where the percentage proportion of members of agricultural societies to the total number of families in the rural areas is 10·9, 10·0, and 8·3 respectively. This also is not a very high percentage but is surely much higher than what it is in other provinces; for instance it is only 1·8 in the United Provinces, 4·4 in Bengal, 2·4 in the Central Provinces, 3·2 in Bihar and Orissa, and 2·9 in Assam.

A period of thirty-two years is no small period of time for any movement to develop well and produce results which may be material. The fact that it has not been so in India means that there is something wrong with the movement which unless remedied will not let it develop quicker. As the Royal Agricultural Commission points out, "The members of Societies delay the repayment of loans even when able to repay ; understanding of the principles of co-operation and knowledge of the essentials of rural credit are lacking, office-holders refrain from taking action against defaulters and the spirit of the self-help is not as prominent as it should be, if the movement is to be a live force in village life."[9] The Provincial Committee on Co-operation in Madras reported the existence of 3,000 dormant societies in the Province in 1928. The Bombay Registrar in his annual report for 1929-30 points out the fact that practically a third of all loans to members are overdue there. In other provinces the situation is worse ; in the United Provinces "there has been a marked and steady deterioration during the past few years in the working of the credit side of the co-operative movement".[10] And as the United Provinces Banking Enquiry Committee points out "co-operation is not yet a living force in the province, save perhaps in a few isolated places".

Reasons for the Slow Growth of the Movement

There are various reasons why the co-operative movement in India has not made as much progress as it made in other countries in comparitively less time. There are two classes of these reasons ; the one class consists of certain extrinsic factors, for which the movement itself is not responsible; and the other class consists of defects in the co-operative system itself.

Extrinsic Factors

There are various national, social and political evils prevailing in this country, which unless remedied will prove a handicap to any movement started to ameliorate the lot of the people. The climate of the country, prevalence of ignorance and illiteracy, unnecessary expenditure on social ceremonies, subdivision and fragmentation of holdings and the systems of land holding and land revenue assessment, have all been responsible for the poverty of the average Indian and the crushing burden of indebtedness which the cultivator and the artisan carry. Mere supply of credit at reasonable rates for current needs will do the agriculturist no good so long as he carries the burden of indebtedness. But relieving him of indebtedness will also not benefit him permanently unless his income is raised and his expenditure reduced. The raising of income will involve consolidation of holdings, improvement of land and methods of cultivation, provision of one or more supplementary occupations and availability of better marketing facilities for the produce. The reduction of expenditure will necessitate sound systems of landholdings and land revenue assessment, supply of sufficient credit at reasonable rates, reduction of unnecessary expenditure on ceremonials by reforming public opinion, encouragement of thrift and the spread of education.

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[9] *Report of the Royal Commission on Agriculture in India*, p. 449.

[10] *United Provinces Annual Report on Co-operative Societies*, 1928—30, p. 15.

Whatever is true for the cultivator the same is true in the case of the artisan except for problems which specifically relate to the soil. But in his case there is the additional problem of decent housing at reasonable rates and of fair remuneration for his labour.

Defects in the Movement

One of the greatest inherent weaknesses of the Indian co-operative movement is the lack of spontaneity. The movement was the result of Government initiative and throughout its existence it has been more or less worked and controlled by the Government. This removes from the movement the very essential element of self-help and self-reliance. The movement in most places in the country is regarded to be an affair of the Government and as such, in many places, is looked at with suspicion and in others with indifference. The other great defect of the system is the lack of understanding of co-operative principles. Most of the people who are connected with the movement, either as workers or as beneficiaries hardly understand the true principles of co-operation. The lack of proper training and education of office-bearers and of co-operators generally is responsible for this state of affairs.

Besides these there are other defects such as accumulation of overdues, defective audit, inadequacy of and delay in finance, red-tapeism, nepotism, etc.

Remedies

Though ultimate de-officialisation of the movement is generally admitted to be desirable, any premature withdrawal of Government control is fraught with grave dangers to the movement. "The aim of co-operation is self-help, and if we have thought it necessary to recommend, for the immediate future, a continuance of official guidance and, to some extent, of official control, we have done so only because we are persuaded that such guidance and control at this stage are essential to the healthy growth of the movement. Whenever co-operators are in a position to supply, from within their own ranks, the leadership and technical knowledge required for the proper control of the movement, we should be the first to suggest the removal of redundant external control."[11]

The most necessary thing for the development of the movement is the patient and persistent education in the meaning and principles of co-operation of members of primary societies. This can be possible when the staff of the societies and the office-bearers are themselves educated in the principles of co-operation. It involves, therefore, the provision of a proper system of education to turn out teachers of co-operation.

The accumulation of overdues is due to the fact that stringent action is not taken against defaulters. To avoid it a careful scrutiny of the economic purpose of the loan and the repaying capacity of the borrower is necessary.

"Audit, supervision and inspection of societies which are closely allied functions are now vested in two and sometimes three different agencies, resulting in much overlapping of work and waste of effort and money. After a full consideration of these points, and of the efficiency of auditing system in European countries like Germany and Austria, we recommend that for the due discharge of the statutory functions of audit special district unions should be formed to carry out audit, supervision and inspection of the societies."

The inadequacy of and the delay in granting loans to members can be remedied by introducing the normal credit system in the societies. If the credit limit of each member is fixed in advance and the necessary finance is granted in time, delay can be avoided by sanctioning applications for loans in advance.

Besides these measures, the selection of the Registrar and Government aid and concessions to societies will go further to strengthen the movement. As the Agricultural Commission recommend the best available man should be selected as Registrar who should hold office for not less than five years while there should be an officer under training in all provinces to succeed the Registrar. Government should spend more towards the expenses of the movement in backward tracts. And certain concessions to co-operative societies which are at present given by Government in some provinces should be given to societies in all provinces.

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[11] *Report of the Royal Commission on Agriculture in India*, p. 451.

CHAPTER XIX

INDIGENOUS BANKING

What is meant by Indigenous Banker—Their Number

BY indigenous banker is meant all those individuals, firms or partnerships, who carry on some kind of banking business on the old time-honoured method. It is not necessary that such individuals, firms or partnerships should carry on only banking business ; they may combine, as generally is the case, banking business with other commercial businesses. Thus the term indigenous banker includes all those from the petty grain merchant who lends small amounts of money in a village to the big *Mahajan* or shroff who is a big financier, who discounts hundis, advances big loans and carries on only banking business over a considerable area through the agencies and branch houses. These indigenous bankers are known by different names in different parts of the country. The most common names are Bania, Mahajan, Chetty, Shroff and Saukar. The actual number of these bankers is not ascertainable. But the following figures as given in the *Report of the Indian Central Banking Enquiry Committee* give enough idea of their number :—

Money-Lenders[1]

Provinces	*Number*
Madras	.. No information.
Bengal	.. 45,000
Bombay	.. 20,000 (estimated including indigenous bankers).
United Provinces	.. No information.
The Punjab	.. 55,000.
Central Provinces	.. 43,000.
Burma and Assam	.. No information.
Bihar and Orissa	.. 100,000.
Delhi	.. 100 (indigenous bankers and money-lenders).
Ajmer-Merwara	.. 17 (indigenous bankers and money-lenders).
North-West Frontier Province	657 (indigenous bankers and money-lenders).

Indigenous Bankers[2]

Madras	.. No information.
Bombay	.. 20,000 (including money-lenders).

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[1] *Indian Central Banking Enquiry Committee Report*, 72.

[2] *Ibid.*, p. 94.

Provinces	*Number*
Bengal	.. Number not ascertained, but it is stated that there are a few indigenous bankers. Number is decreasing).
United Provinces	.. 250 (Estimated number of indigenous bankers who are willing to receive deposits).
The Punjab	.. 66
Burma	.. 1,650
Bihar and Orissa	.. 100,000 (including money-lenders).
Central Provinces	.. 1
Assam	.. No information.
Central Areas	.. 29 in Ajmer, 43 in Delhi and 29 Hindu bankers in N.W.F. Province, besides a large number of Muslims.

On an examination of the above tables, on even a conservative estimate, the number of indigenous bankers in India is very large. Thus there will hardly be a place in India where one or more indigenous bankers may not be present. Down from the smallest village to the biggest presidency town, the indigenous banker exists in one form or another.

Place of Indigenous Banker

Banking is a very old institution in India. And though no connected historical account of the indigenous banking system seems to have ever been written, there is ample evidence to show that banking in India was practised in very ancient times. During the middle ages and the Mahomedan periods, the indigenous banker carried on his business during the Moghal period and later had political significance is so far as some of the big houses were State financiers. With the advent of the British rule and the growth of joint-stock and co-operative banking, they have though lost their political prestige and monopoly in their trade, yet they are holding their own in their restricted areas, and the indigenous bankers even to-day play no mean part in financing the internal trade and agriculture of the country.

Hereditary Business

"The business of the indigenous banker is purely a family concern and hereditary in the family. So banking business in India is usually conducted by a class or caste."[3]

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[3] *Present-day Banking in India*, Rau, p. 120.

In the villages it is usually the village Bania who is also the local grain dealer who lends money to the cultivators, in towns it is either the grain dealer or the shroff, who conducts jewellery business also, who lends money to artisans, small shopkeepers and other individuals. In big commercial and other towns there are the big grain merchants, saukars, shroffs and purely indigenous banking houses, who draw hundis and discount hundis and traders' bills, advance loans on the security of land and property, carry on pawn-brokers' business, and in a few cases also receive deposits.

Hundi Business

The big bankers, some of whom are big enough to transact business outside their towns through the agencies of *Munims* and *Gumastas*, chiefly carry on the business of drawing and discounting hundis[4] and discounting traders' bills. Thus these bankers finance the internal trade of the country to a great extent by the issue and discounting of hundis and act as middlemen between the Indian commercial community on the one hand and the Imperial Bank and other joint-stock banks on the other.

Act as Middlemen

Shopkeepers and merchants with limited means of their own cannot get advances from the joint-stock banks ; they therefore approach the shroffs who, after very careful enquiries into the shopkeeper's postion, grant the accommodation. In such cases, the shroff may advance loan and draw a hundi on the shopkeeper which the latter accepts, or may discount the hundi of the shopkeeper. Since the capital of the shroff is generally limited, he may get some of the hundis rediscounted with the joint-stock banks who readily rediscount such hundis as they bear two signatures. In acting as a middleman between the banks and the trading community the shroffs first discount traders' bills and then get them rediscounted with the joint-stock banks and the Imperial Bank. This process was necessary in the case of the Imperial Bank as it could not discount a bill which did not bear two signatures; and in the case of joint-stock banks, the endorsement of the shroff means additional security, and they readily discount such bills.

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[4] *Hundi* is a bill of exchange usually written in Mahajani.

It generally runs for odd number of days—41 days at Benares, Bombay, Lucknow; 61 days at Fatehgarh and Furrukhabad; 121 days at Lahore and Multan. Hundis are of two kinds, *Darshani* (payable at sight or on demand) and *Muddati* (payable after a certain period of time). Hundis are discounted like bills of exchange and the rate of discount is called *Hundiyana*. The dishonouring of a Hundi is rare. If they are not honoured on due dates the drawers are considered bankrupt. A hundi, however, differs from a Bill of Exchange in so far that while a bill must be an unconditional order, a hundi may not be so, *e.g.*, a *jokhmi hundi* which is like a documetary bill and contains certain conditions according to which if the goods are lost or destroyed during transit the drawer or the holder of the hundi has to suffer the loss.

A DARSHANI HUNDI

॥ श्री ॥

नंबर
रुजु

STAMP

सिद्ध श्री मुंबई महा शुभस्थान भाई जोगमल नत्थीमल जोग श्री पूना सूं खेमराज हुकमचन्द की श्री जुहार बांचना। उपरंच हुंडी १ रू. ५००, अक्षरी रुपया पांच सौ का निमे रुपये दो सौ पचास का दूना पूरा इहां राखे भाई मोतीलाल रामलाल पास पुगे तुरत पिछे नामे साहत्रोग ढाव ठिकान घर चवकस कर के रुपया हुंडी चलन का देना।

सं मिती………………………………का

दस्तकत

A MUDDATI HUNDI

॥ श्री ॥

नंबर
रुजु

STAMP

सिद्ध श्री मुंबई महा शुभस्थान पत्री भाई जोगमल नत्थीलाल जोग श्री पूना सूं खेमराज हुकमचन्द की श्री जुहार बांचना। उपरंच हुंडी १ रु. ५०० अक्षरी रुपया पांच सौ के निमे रुपये दो सौ पचास का दूना पूरा इहां रखे भाई मोतीलाल रामलाल पास मिती चैत सुदी १२ से ५१ दिन पिछे पैंचे दाम की नामे धनीशाह जोग टिकाना लगाय चौकस कर दाम देना। हुंडी लिखी मिती चैत सुदी १२ संवत १८५३—

Hundi for Transmission

The hundi is also used for transmitting money from one place to another. Though this function of the hundi was very important till some time back, it has become less so now with the development of railway communication and postal facilities ; and other means of transmitting money, such as money orders, currency transfers, bank drafts and the splitting up of currency notes into two parts and sending each part separately have become more common.

Hundiyana

The 'hundiyana' or the discount rate of hundis varies with the standing of the party and is always above the bank rate of discount. In the case of a first-class borrower the rate charged is generally 2 as. per cent. per mensem or 1½ per cent. above the bank rate of discount. Rates in Calcutta and Madras are on a higher scale because of a lesser competition among shroffs here.

Advance Loans

It should, however, not be understood that the above bankers conduct only the hundi business. Besides jewellery and other commercial business, they advance loans to all sorts of customers on the security and mortgage of landed and house property and jewellery. Such loans have no general rate of interest. The rate of interest charged is generally high and varies considerably according to the standing of the borrower, the value of the security offered and the urgency of the need of the borrower for the loan.

Deposits

Only very few of such bankers receive deposits. They mostly carry on business with their own capital. Those amongst them who do receive deposits now and then, pay the market rate of interest on such deposits. But they, in most cases, receive deposits only from friends and acquaintances and not from businessmen, as they know that deposits of businessmen may be called at any inconvenient time. The indigenous bankers do not generally receive current deposits and thus do not create the cheque currency.

Village Money-Lender

So far as the village money-lender is concerned, he is generally the local grain dealer, with small resources who supplies small sums to the cultivator, both for agricultural purposes and for domestic and ceremonial expenses. The regime of the village money-lender is the most defective imaginable. His resources are extremely limited. He follows no rules except those of his conscience, which is very elastic. His ledger admits of no audit and the borrower cannot check it. His rate of interest is regulated more by the urgency of the need of the borrower than by the value of the security offered. He deos not distinguish between different sorts of loans, nor does the borrower. "On the other hand, since it is impossible to trust the individual money-lender with the powers destraint or other summary recovery, he is put to considerable expense, delay, loss and fraud, in the recovery of his loans, a loss which he recoups with a handsome increment from his clients so that the punctual and the honourable borrower pays for the offences of the defaulter" (Nicholson).

Only Agency of Finance

But in spite of the above charges against him, the village money-lender is the only agency at present on which every Indian cultivator can rely for the supply of funds. The Indian cultivator is very poor, he has worthless security to offer, wants small sums from time to time and is generally unpunctual in payment. No other agency than that of the village money-lender will be willing to offer loans in such conditions. The village money-lender if he, therefore, charges high rates of interest, is not altogether unjustified in doing so.

Replacement of the Money-Lender or Improvement

The only remedy as suggested by some against the defective and tyrannical regime of the money-lender is to replace him by some better agency. A step in this direction has been taken in India by the institution of the co-operative credit movement. But the co-operative credit movement is yet in its infancy and has done little to ameliorate the financial condition of the ryots. And as the Indian Central Banking Enquiry Committee point out "the money-lender is an indispensable feature of Indian rural economy. He is easily accessible. His methods of business are simple and elastic. He maintains a close personal contact with the borrower, often having hereditary relations with the family of the borrower. His knowledge and experience and his presence on the spot enable him to accommodate persons without tangible assets and yet protect himself against losses". This will make it clear that the absolute replacement of the money-lender is neither possible nor desirable. A better step would be on the one hand to develop the co-operative movement, and on the other to remove the existing defects in the money-lending system and improve it in order to make it more useful. The various Provincial Banking Enquiry Committees have recommended a compulsory registration of all professional money-lenders and the issuing of licenses, to carry on money-lending business, only to those who registered; while the practising of money-lending without a license may be punishable at law. The licenses should confer certain privileges and impose certain restrictions on the registered money-lenders. A maximum rate of interest above which no money-lender may be allowed to charge should be fixed, the money-lenders should be required to keep accounts in standard form and allow them to be inspected by a Government auditor. The account of each individual borrower should be separately kept and a copy of it should be furnished to the borrower whenever he may so desire. Against these restrictions the registered money-lenders should be able to get money advances against their agricultural paper from the joint-stock banks and the Imperial Bank and get from them same remittance facilities as are allowed to banks by the Imperial Bank and to co-operative societies by the post office. The joint-stock banks and the Imperial Bank should be induced by the Government to do so.

Advantages of Compulsory Registration

We think that the compulsory registration above suggested will to a great extent go to improve the rural money-lending system in India. Not only will it go to raise the status of the money-lender and increase his resources and thereby raise his morale and increase his usefulness, but will also be a very effective check on most of his undesirable practices and will be instrumental in weeding out many money-lenders whose disappearance may be more desirable than their existence. The Indian Central Banking Enquiry Committee do not agree with this suggestion. They think that the introduction of the system of licensing money-lenders is not necessary as the main objectives of it (*viz.*, the reduction of high rates of interest charged by the money-lenders and the removal of their dishonest practices) can be realised by a spread of education, the extension of co-operative and joint-stock banking and the training of the borrower in the habits of thrift and saving, on the one hand ; and the introduction in other provinces of a similar legislation to the Punjab Regulation of Accounts Act on the other. No one can doubt the necessity of spreading education, encouraging thrift and extending co-operative and joint-stock banking. They are in themselves desirable and will certainly go to remove many of the evils of the money-lending system. But they are reforms which will take time to spread themselves and may even then be not effective enough in the removal of all the evils. The need for the reconstruction and improvement of Indian Rural Finance is imminent and great. Any delay in this direction will cause deterioration in the economic condition, which is already too bad, of the bulk of the Indian people. It is necessary, therefore, to take drastic steps and not to leave the improvement to slow and gradual processes. The licensing of the money-lenders is a step which will produce an immediate effect and will not at the same time interfere with any process of slow and gradual reform in the same direction.

Other Improvements

Besides the licensing of money-lenders, other improvements (as suggested by the Indian Central Banking Enquiry Committee) should also be effected to further remove the evils of the money-lending system and increase the usefulness of the money-lenders. Those money-lenders who cease to lend privately to the members of co-operative societies may be induced to join such societies, and may work on their managing committees. This will increase the resources of the co-operative societies and bring the experience of the money-lenders inside the co-operative movement. Efforts may be made to form co-operative societies of money-lenders which should lend to primary societies and not to individuals. Joint-stock banks may entrust to registered money-lenders some of their agency functions (accepting deposits, making remittances and payments, etc.) and if this work is done by them satisfactorily and if there is enough business they may be transformed into full-fledged branches of the banks. "This would remedy one of the obstacles to branch banking in India, namely, the complete ignorance of the urban banker as to the conditions prevailing in mofussil and the high cost of running a full-fledged branch in the interior with a responsibe manager."

Indigenous Bankers' Defects in their Business

We have seen the main types of business that the indigenous bankers conduct and we have also seen that they conduct their business on the old time-honoured methods without in the least caring to improve or adapt their methods to modern conditions. Besides this ingrained partiality to their old system, the fact that the indigenous bank is a purely family concern, and the business is handed down from father to son, makes the infusion of new ideas and the introduction of better methods very difficult.

Do not Receive Deposits

The indigenous banks, as we have seen, do not receive deposits as a rule. They carry on business with their own capital. No bank can possess enough capital to transact a fairly large business. Their usefulness, therefore, on this side is limited by the amount of their capital, while the other and more important side—the mobilising of the country's capital and the introduction of cheque currency—is totally neglected.

Not a Scientific Banker

The indigenous banker is not a scientific banker. His accounts are not kept on scientific lines. His investments are not made in quickly realisable assets, but on the contrary, he prefers land, property and other fixed assets. He does not distinguish between different kinds of loans, and never forbids gross speculation or refuses to support overtrading or overinvestment. His only care is to make profits ; it is not his concern how does he make them, either by exploiting the poor and the needy or by supporting undesirable ventures. He does not recognise the responsibility for the harmonious development of commerce and industry that rests on the shoulders of banks.

Do not Manufacture Credit

The indigenous bankers are merely brokers in credit. They "have done very little to manufacture credit. Their bills of exchange, *i.e.*, hundis, are merely a species of mercantile exchange. They have never manufactured credit by the issue of notes. They have not financed manufactures on a large scale."[5]

Do not Render other Services

Modern banks, besides receiving deposits and advancing loans, render various other services, and act as financial advisors to their customers. The indigenous banker does not render any such services ; and he is very reluctant to offer any advice to his customers, since he does not want any one else to benefit by his knowledge.

Combination of Business

And lastly, the indigenous banker generally combines the banking business with commercial business or with some other profession or occupation. Such a combination is against the very principle of banking. Banking business and commercial business are quite different in nature. Any combination of the two can never be harmonious, and will always introduce an element of speculation and instability in the banking business.

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[5] *Present-day Banking in India,* Rau, I, p. 142.

Improvements

The banking system of a country must adapt itself to the needs of the country, it is only then that it can be fully useful to the country. India is not in the same stage of production now in which she was only a few decades before. In the present stage, therefore, the indigenous banking system conducted on time-honoured and stereotyped lines cannot suit the needs of the country. It should be reformed and brought on modern lines; and those who conduct it should recognize the full responsibility which lies on a banking system for the development of commerce and industry and the money power of the people of the country which it serves.

Strengthen their Position

The Indian Central Banking Enquiry Committee point out that some of these indigenous bankers do need encouragement in order to help them out of difficulties which are beyond their control. That the indigenous bankers are important institutions for financing internal trade and middle-sized and small industries and inland remittance work even where joint-stock banks exist; and they are the sole agency of finance where joint-stock banks do not exist.[6] The bulk of the work of financing business in the country is thus dependent upon the indigenous bankers, while the progress of joint-stock banking and co-operation to the extent that they may replace the indigenous banker will take too long a time. "We think it, therefore, of the greatest importance that in the interests of both the general public and the indigenous bankers themselves steps should be devised to strengthen the position of these bankers."[7]

Recommendations of the Banking Committee

They are not, however, in favour of any compulsory measures in this direction, for they think that such measures will not be welcomed by the indigenous bankers and may, on the other hand, accelerate the process of driving them out from banking to other spheres of business. With this idea in mind, and with a view to restoring the indigenous bankers to the place they enjoyed in India until the middle of the last century, the Indian Central Banking Enquiry Committee make the following recommendations:—

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[6] Out of 25,000 towns in India in less than 400 any joint-stock bank or its branch exists.

[7] *Indian Central Banking Enquiry Committee Report*, p. 107.

(1) That the Reserve Bank, when it is created, should provide rediscounting facilities to such indigenous bankers as are engaged in banking proper or are prepared to shed their business other than banking, possess a certain minimum capital, and agree to keep proper books of accounts in the usual recognized manner and to have them audited annually by recognized auditors.

(2) That the abovementioned indigenous bankers should become full members of the proposed All-India Bankers' Association and should be entitled to use the designation "Members of the Central Bankers' Association". This will raise the status of these banks and will improve their banking methods.

(3) That such indigenous bankers as have been placed on the approved list of the Reserve Bank may be used by the Reserve Bank and the commercial banks as agents for collection of cheques and bills.

Other Suggestions for Improvements

Mr. V. Ramdas Pantulu, in his minute of dissent appended to the *Report,* feels that the above "arrangements by themselves will not help to develop indigenous banking system as a whole, and arrest the decay that has already set in into the working of that system". He is in favour of reform of a larger magnitude and more far-reaching character, which will confer on the indigenous banker the status of a banker *qua* banker. He, therefore, recommends the registration of all those indigenous bankers who wish to avail themselves of the provisions of the Bank Act recommended by the Committee. Such a registration, not being a 'writ of restraint but a charter of rights' will be enthusiastically received by the indigenous bankers themselves, for it will raise their status, enlarge their resources and expand their business. Under it, they will be carrying on banking as recognized bankers and will submit themselves to regulations which will make their business more efficient and safer and will thus inspire confidence in the public. " The Reserve Bank will necessarily have to make its choice, for enlistment on its rolls of banks and bankers entitled to discount and rediscount facilities, from the ranks of the registered indigenous bankers. The Imperial Bank will similarly have to choose for its agency work for collection only registered bankers and so too it must offer discounting facilities only to members of that class. The associations of the registered indigenous bankers will then have a wider influence and a higher prestige than those of a nebulous class. The whole organization will thus undergo a marvellous change and a new orientation will be given to the indigenous banking system."[8]

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[8] *Indian Central Banking Enquiry Committee Report*, p. 529.

CHAPTER XX

BACKWARDNESS AND DEFECTS OF INDIAN BANKING

General Defects

OUR banking system as it exists to-day is conspicuous by its backwardness. It is not developed, is not popular, is not sytematically organized and is only one sided. There are but a few modern banks in the country, and these too are of a pigmy size as compared with banks in other countries. These banks which exist serve an infinitesimal portion of the country's population, and confine their activities only to commerce, a part of which alone is financed by them. The banking system of the country is not only inadequate but is also disorganized and weak. It is not even able to tap all the existing sources of capital in the country, much less to say of being able to find out new sources and develop the existing ones.

An efficient banking system is one which is closely knit together, is strong and inspires confidence, which mobilises the available capital from every nook and corner of the country, and distributes it in a way that all the economic activities of the country get their due share. It is its business to see that none of these gets an undue proportion of capital while another starves for want of it. Its first concern should be the economic development of the country that it serves. The banking system of India, unfortunately, falls far short of this ideal ; and that is one of the chief reasons of her economic backwardness. For, be it remembered, that much of the economic prosperity of a country depends upon its institution of banking. The banking systems of Germany and Japan have amply demonstrated, what a well organized and efficient banking system can do for the economic development of a country.

One-sided

In India there is only one type of banking activity, which deals in short-term credit. The Imperial Bank, the Joint-Stock Banks and the Exchange Banks all transact only short-term credit operations. They are all commercial banks. There do not exist in the country other institutions which can adequately assist other economic activities like industry, agriculture, land and forest development, etc. There are no Industrial and Land Mortgage Banks ; the Co-operative credit societies are in an undeveloped state and have not even touched the fringe of the problem of helping the ryot, they are as yet only in their infancy with very doubtful prospect of growth under their present organization. There is no arrangement for rendering financial assistance to the lower ranks of middle class people and to small artisans. The commercial banks give them no countenance, and they have to, like ordinary cultivators, fall prey to the money-lender.

Non-development of Banking Habit

The banking habit has not been developed amongst the people. They are still in the habit of hoarding their savings, instead of utilising them for earning income. The banking system of the country has not been able to inspire enough confidence to induce people to entrust their savings to the Banks. The result is that the country loses the use of so much potential capital. Not only this, but on account of their non-banking habits, the people are thriftless and extravagant and their productive capacity is very low. And this explains to a large extent the inadequacy and lack of banking capital.

Loose Organization

The Indian banking system is not a closely knit organization. In fact, there is hardly a banking system worth its name. The banks in India are scattered isolated institutions, each doing business for itself. They have no sympathy and goodwill for one another ; on the contrary they are constantly competing and there is no love lost amongst them. The Imperial Bank, the Exchange Banks, and the Joint-Stock Banks all work severally and not collectively. In times of difficulty each bank has to stand by itself ; there is no question of mutual help and assistance.

Absence of a Central Bank

India did not possess a Central Bank till very recent times. We have seen elsewhere how necessary is the existence of a central bank for exercising a co-ordinating influence over the whole banking system and the money market, and for making the banking system stronger and more organized. Besides, the lack of a central bank means the lack of rediscounting facilities, and the separation of banking and currency reserves and functions. A central bank alone can properly be a note-issuing institution. In India till now the currency authority was the Government of India which was not in a position to expand and contract the currency of the country according to the needs of the country. The result is that the rates of money in India are widely fluctuating.

Unstable Money Market

An efficient banking system should secure stability in the rates of money. The Indian money market is the most unstable. The discount rate of the Imperial Bank will bear out this contention. Fluctuations in its discount rate are rapid and great. Business and industry cannot flourish under such conditions of uncertainty.

Inelastic Currency

"The paper currency established fully answers the purpose of easier means of exchange than gold or silver ; but no connection whetever exists between the issue of the fiduciary currency and the wants of the public to have their bills or other commodities converted into a current medium of exchange and this is the sole cause of the unexpected convulsions and sudden transitions in the money market, so utterly detrimental to business, to which the British Indian trade is constantly exposed."[1] The proper institution for securing an elastic currency is a central bank, which by granting loans or creating credit instruments of short duration can meet the seasonal demand for money, and which can automatically cancel the intruments of loans when the demand for currency slackens.

Unstable Banking

Again the structural stability of Indian Banking does not rest on a solid basis. The whole system is liable to be upset by a financial crisis, or a severe run or a sudden demand for withdrawals of money. This is because it possesses a multiple reserve system, without a sufficient cash reserve to maintain it on that basis. The Exchange Banks undertake immense liabilities without adequate reserve. The joint-stock banks do business on a scale, which their resources do not warrant ; some of them even go to the length of indulging in speculative business.

Decentralised Reserves

In a time of panic or a run, lending freely is the only method of averting the crisis. But in order to lend freely a bank ought to be helped by other banks ; the resources of any one bank are limited. This can be done by a single reserve system with the central bank. It is necessary, therefore, that all the banks in India should be co-ordinated, so that they can rely upon the central bank for assistance whenever they may be in difficulty.

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[1] *Money and Money Market in India,* Wadia and Joshi.

Absence of Industrial Banks

On account of the absence of Industrial and Investment Banks, commercial banks are involved in taking up a few of the functions of these. This results in a double loss, firstly the commercial banks are drawn into lending to industrial concerns, and to this extent the genuine and growing commercial needs of the country are starved. And secondly, the commercial banks, by combining industrial finance for which they have neither the aptitude nor the requisite machinery, carry on risky business and thereby weaken their position and suffer through it. Thus commerce suffers, industries are not financed to any appreciable extent and the banks are involved in risky transactions.

The responsibility of the backwardness of Indian Banking does not, however, rest only on the shoulders of the banks. The people of India, and more so, the Government of India are as well responsible for it. Tne Government have always shown a want of sympathetic attitude, and have never considered banking development as a necessary duty of the State.

Copy of English System

In fact, it is the chief features of the English Banks which the Indian Joint-Stock Banks have copied. The Government of India have also followed the British Government in their *laissez faire* policy in the matter of banking. "Imitation for imitation's sake has produced unworthy specimens. The superficial elements alone have been copied while the really vital and progressive features of English Banking have not been engrafted on our system. Banker's associations, banker's institutes and guilds have not been created on the English model."[2] Besides this only a part of the financial system alone has been imitated. England possesses in the Bank of England the strongest, the most efficient and the most conscientious central bank. In England, besides banks, there are trustworthy promoters and issuing houses, which aid industrial concerns ; India possesses nothing of the kind. And over and above all this there is a vast difference between India and England in the economic condition and problems. Commerce and Industry are well established and prosperous in England, her people are well versed in financial matters and her industries have never felt the want of capital. India, on the other hand, is primarily an agricultural country, her people are conservative and ignorant, her commerce and industry are in an undeveloped state and require every means for their development and growth. She is a vast country, and the bulk of her people is poor, with but small savings. The banking system to suit such a country is not one which exists here to-day.

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[2] *Present-day Banking in India,* Rau, p. 202.

Absence of Banking Law

There does not exist in India a requisite machinery to control and regulate the flotation and working of banks. There is no separate Banking Law ; the Indian Companies Law applies to banking also. Thus there is no provision for a rigid security of the scheme before granting certificate of incorporation ; to demand a certain proportion of the capital and directorate to be national ; to fix a minimum amount of paid-up capital and cash reserve in respect of deposits ; and to demand publicity of accounts and statements of position.

Foreign Domination

The Indian banking system is dominated by non-Indians whose real sympathies and interest are not with India. Their only aim is to earn the highest profits and to exploit the poeple to the extent that they can. The financing of our rural trade and internal trade to some extent nad our international trade to a large extent is in the hands of the foreigners, who are exploiting our agriculture in their own interest. The Exchange Banks are all foreign banks, and they finance our foreign trade. "They display no desire to take part in the economic reorganization of our country. They have no ambitious national programme for India's uplift. ...... They are more willing to help their own countrymen and trade with European business firms and are not anxious to attract the accounts of small and new firms started by the Indian people." [3]

No Attempt to Develop Money Power

Another feature of our banking system is that no attempts are being made to develop the money power of the country by the existing banking institutions. The minimum amount with which a banking account can be opened is much higher in the case of India. Indian banks do not make any provision for non-English knowing customers ; cheque books and pass books are not issued in vernaculars. The business is conducted entirely on foreign lines, which is not familiar to the average Indian who, therefore, has not got in such institutions that confidence which is necessary.

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[3] *Present-day Banking in India,* Rau, p. 206.

Lack of Banking Training

Sound and good banking to a very great extent, will depend on efficient bankers. India lacks efficient bankers. Trained Indians in both theoretical and practical banking are not available and banks have either to employ foreigners on high salaries and thereby make their costs high or have to rely upon untrained inefficient Indians. Until the end of the last century, commercial and banking education in this country was altogether non-existent. Recently some theoretical training in these directions is imparted by a few Universities and colleges in the country. But it is only to a very small extent that any advantage is taken of such facilities, obviously on account of the fact that the trained are not in a large demand. This is mainly due to there not existing any co-ordination between the universities and the banks in India. "The universities do not appear to have devoted much thought to the question of giving their commercial courses a more practical turn than is the case at present. On the other hand, banks do not appear to attach much value to the theoretical instruction in banking given in the commercial schools and colleges, nor do they provide facilities for supplementing such instruction by practical training."[4]

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[4] *Indian Central Banking Enquiry Committee Report*, p. 488.

CHAPTER XXI

SUGGESTIONS FOR REFORMS

THE need for a thorough overhauling and reorganization of our banking system is undeniable. India needs a banking system which is capable of not only financing commerce but also all the other economic activities of the country; one which is strong and able to inspire confidence; is able to mobilise all the existing savings of the people and to develop their money power by inculcating in them the habit of thrift and stimulating and directing into proper channel their saving energy; one which has for its aim the economic development of the country first and the idea of profits only after it, which should be national in character and national in its outlook; and one which can adapt itself perfectly to the conditions and circumstances of the country.

Need for Various Kinds of Banks

The Banking System of India in order to be complete should consist of a Central Bank, which will be the centre of the whole banking system and its pillar of support; Commercial Banks; Indian Exchange Banks; Agricultural Banks, both co-operative and land mortgage; Industrial Banks; Investment Banks and Savings Banks.

A Central Bank

The question of a Central Bank for India has already been discussed at length in one of the previous chapters. It will be needless, therefore, to repeat it here over again. The need for a Central Bank, with powers of issuing notes and which will act both as a banker to the Government and as a bankers' bank, cannot too far be emphasised. The need for such an institution is the first and the greatest, for without its creation no amount of banking reform can be of much use. The Central Bank, in fact, is the pivot of the money market; without it a banking system will be just like a building without a foundation. A Central Bank—The Reserve Bank of India—has, however, recently been created to fulfil this need. It is yet too early to comment on its working and usefulness. The future alone will show as to how far it justifies its existence.

Industrial, Land Mortgage and Exchange Banks

Besides this, Indian Industrial, Land Mortgage Banks and Exchange Banks should be started; Industrial Banks which will specialise in industrial flotation and in granting long-term loans to industrial concerns; Land Mortgage Banks, which will extend long-term credit to the land-holding classes, and thus finance permanent improvements in land and agriculture; and Indian Exchange Banks, which will finance our foreign trade which to our detriment is being now financed by foreigners.

More of Commercial, Co-operative and Savings Banks

The commercial banks, co-operative banks and savings banks already exist in the country, but their number and size are small, and their state not very satisfactory. More of such institutions should be started in every part of the country, and the condition and organization of the existing ones should be greatly improved. Almost all the important commercial banks of the country are owned and managed by foreigners. No doubt in recent years many Indian commercial banks have been started, but they are yet few, their size comparatively small and their condition not very satisfactory. In order to have more commercial banks owned and managed by Indians, the existing banks should be encouraged. It should be the concern of every Indian businessman to patronise the banks of his own country and thus afford stimulus to the growth of indigenous enterprise.

Co-operative Movement

The Co-operative Credit Movement as we have said earlier, is yet in its infancy and has very doubtful prospects of progress under its present organization. The need for the development of Co-operative Credit Societies is very great in the case of India. What the co-operative movement could do in Germany in ameliorating the lot of the agriculturist, in saving him from the clutches of the money-lender and in bringing its agriculture on a sound footing, is evident from the present prosperous condition of German agriculture and cultivators. The same result can be achieved in India also by a well-organized and a country-wide co-operative movement.

What are the defects in the present co-operative credit organization in India and how to remove those defects, have already been discussed in a previous chapter on Co-operation; it will be unnecessary repetition to once again discuss them here. For want of space we shall however, point out that whatever be the defects they should be removed immediately and the co-operative movement should be brought on better lines in order to be more useful than it has hitherto been.

Improvement of Money-Lending and Indigenous Banking

The development of co-operation does not however mean the entire displacement of the indigenous banker and the money-lender. These institutions are engrained in the Indian system and cannot easily be displaced nor is their entire displacement desirable. What is necessary is their improvement with a view to remove their defects and to make them more useful than they at present are. The improvements as suggested in a previous chapter on Indigenous Banks, it is hoped, will make them much more useful and will go a long way in the development of banking habit and thrift among various classes of people in the country on the one hand, and in making possible availability of capital for various productive enterprises which cannot be reached directly by the joint-stock banks, on the other.

Savings Banks

The Post Office is the chief agency in India which carries on the savings bank business. Post Office Savings Banks have done useful work in at least serving the lower middle class of the population. They are, however, not taken advantage of by other classes. Savings Banks are, in fact, primarily meant to serve the poor. The Indian Savings Banks have not been able to do this. In order to make the Savings Banks more useful their business should be improved on the lines suggested earlier and more of them should be started, particularly in the rural districts. If the co-operative credit societies open savings bank department also, there is no reason why savings banks will not be popular amongst the agriculturists. Besides these, Municipalities and other local boards can also start savings banks.

More Capital

An important thing needed to make our banking system complete and to make the existing system more stable is capital. Capital is necessary in order to start new banks, and to make the existing banks stronger and more useful. Capital in India is said to be shy, not so much scarce. India is believed to possess fabulous hoards of precious metals, which do not come out for investment on account of the conservatism and ignorance of her people. Indian capital is certainly shy, but it is scarce also. The habit of hoarding still persists amongst some of the people, but the hoards are certainly not fabulous. The extreme poverty of the people and their very low standard of living are not consistent with fabulous hoards. There is no appreciable margin in the income of the people to allow them to accumulate these huge hoards. Small sums are certainly saved for a rainy day, but they vanish with the frequent occurrences of famines and pestilences. Again the appalling indebtedness of our peasantry is too well known to need any comment. It is beyond reason to believe the existence of both huge indebtedness and fabulous hoards side by side.

Development of Industries and Agriculture and Change in Fiscal Policy

It is really the scarcity of capital which is the chief malady with which India is suffering at the present day. The earning power of her people is very low. The reasons for this are many, but the chief ones are two, *viz.*, the unsympathetic attitude of an alien Government towards the economic development of the country, and the annual drain of money from India by way of home charges. It has truly speaking never been the honest concern of the Indian Government to develop Indian industries, agriculture and commerce. The proportion of their expenditure on the army and civil service as compared with that on education, public health and commerce and industries; their fiscal policy as affecting our foreign trade and their encouragement to British investments and British trade amply justifies this accusation.

Removal of Foreign Domination

The annual drains in the shape of home charges reduce the annual income considerably and the national dividend is correspondingly reduced. "There is no legitimate ground for grievance so far as the home charges are direct payment for services rendered to India but an appreciable amount goes away from our country as profits of industries managed and financed by Europeans. Here is the legitimate ground for complaint." Foreign domination in the field of finance, commerce, industry and capital have all led to the exploitation of Indian people and the country's resources. They, instead of developing the earning power and the money energy of the people, have in fact reduced them considerably. That country is in the strongest position whose capital is self-generated and self-employed. The first concern of the people of India and of the Government should be to rid the country of the domination of foreign capital.

Spread of Education and Facilities for Investments

Not only is Indian capital scarce but whatever amount of capital exists is not employed fully for productive purposes. If there are not fabulous hoards there certainly do exist small hoards, and when aggregated these small scattered hoards may form big amounts. The chief reasons responsible for the hoarding habit of the people and their non-economic outlook are the illiteracy and ignorance of the people and the lack of properly organized institutions to inculcate in the people the habit of thrift and to afford them facilities for depositing their small savings. The introduction of the gold certificates, as recommended by the Hilton Young Commission, for legal tender money and redeemable after three or five years either in legal tender money or in gold at the option of the holder ; the encouragement in the habit of using cheques, by the use of vernaculars, by the acceptance of cheques for Government and local bodies charges, by the provision of adequate facilities for prompt encashment of cheques by banks and by the acceptance of cheques by post offices and co-operative societies ; and the starting of savings associations are all necessary for this purpose.

Savings Associations and Thrift Committees

The various Provincial Banking Enquiry Committees have recommended the inauguration of savings associations or thrift committees on the lines of the National Savings Associations in England. "We support in principle the formation of such associations in all provinces. The educative effect of such organizations working systematically in different parts of the country with the zeal and spirit of service essential in a cause of national importance, would be immense. By active propaganda for encouraging small savings, by providing means for the collection of such savings and by pooling them for remunerative investment in approved securities, they would succeed in promoting the saving habit among the young as well as old, in overcoming the timidity of the small saver and in familiarising him with practically safe and profitable means of investment."[1]

Propaganda

A well-organized banking system will go a long way in educating people in the practice of investment. Besides this, education and propaganda are also necessary. "The agriculturists and the mofussil traders should be taught that a bank affords the best store of value relieving them of the risk and trouble of keeping large stock of precious metals in their house. The advantages of banking account have to be inculcated into their minds."[2]

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[1] *Indian Central Banking Enquiry Committee Report,* p. 447.

[2] *Present-day Banking in India,* Rau, p. 217.

Development and Increase of Branches

Along with the starting of new banks of the existing types and of other types, the existing banks should be made to extend their branches into the interior and establish a network of banking establishments. "The opening of branches will afford an outlet for the surplus capital at the head office and minimise the danger of its being invested in hazardous undertakings. They afford facilities for transmission of money from one place to another, and can easily bring about a distribution of capital according to the relative needs of time and space. ...... The opening of branches all over the country would lead to a lowering and steadying of the rate of interest to a great extent. It will lead to an increase of loanable funds. The branch bank system may be extended to places too small to support a regular bank which requires a full complement of officers and reserve coin."[3]

The system of branch banking has been successful in almost every economically advanced country of the world. In the United Kingdom, the Continental countries, Japan, Australia and Canada, branch banking has become very popular and has proved very successful in making their banking systems countrywide. There is no reason why India should not learn and profit by examples set by these countries.

Banking Training

In order to have efficient banks there is first the need of efficient bankers. In India there is a very great scarcity of trained bank employees and trained bank managers possessing practical and theoretical knowledge about banks. One of the reasons assigned to the frequent bank failures in India is the inefficiency of the banks' staff. In every advanced country there is an adequate provision for training in banking. As Mr. Findley Shirras points out, "In England and Scotland, for example, young men at the age of seventeen or eighteen begin a long period of training in bank offices and, in addition to this practical side of the work, they pass examinations held by the Institute of Bankers, by similar bodies and by the banks themselves". The need for similar arrangements is very great in the case of India, and without it India will have to continue to rely upon the services of foreigners.

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[3] *Present-day Banking in India*, Rau, p. 222.

Bankers' Association

For the purposes of holding examinations and for bringing about co-ordination and better relations among the various banks, bankers' associations are necessary. The aims of such associations, besides creating good relations, are to provide a common meeting place for the various banks to assemble and discuss their common topics, to decide amongst themselves and to fix suitable rates and thus try to eliminate competition and rivalry, to educate banking staff by arranging lectures and classes, maintaining libraries and reading rooms and issuing banking literature in the form of magazines, books, pamphlets, etc. They also conduct examinations, and bring about banking reforms.

The results achieved by such associations in countries where they exist are marvellous. They have been able to introduce better methods in banking, and better morals. The efficiency of management and the solidarity brought about by these associations have made severe panic occurrences of the past, and though crisis still occur, they are not very severe and the rude shocks of sudden panic are altogether unknown.

Banking Legislation

Last, though not the least, is the necessity of having banking legislation. As we have said earlier there is no separate banking legislation in India. The Joint-Stock Companies Act applies to banking concerns also. Banking business is essentially different from other kinds of commercial and industrial businesses. Banking Law should be separate from the law relating to ordinary joint-stock companies. It will be in the interest of better banking practice, and a more stable banking system if the safeguards of sound banking were adopted. The restriction of the term 'bank' to banks proper, the requirement of a minimum paid-up capital before the bank is allowed to start its operations, the restrictions for granting loans and discounting bills and the requirement of a minimum cash reserve are some of the very necessary provisions which banking legislation should contain.

Special Bank Act

The Central Banking Enquiry Committee have recommended the promulgation of a special Bank Act comprising the necessary provisions governing all banking institutions. They suggest the Act to provide among others, the taking out of licenses from the Reserve Bank by all Indian banks ; the Indian banks to have a majority of natural born or domiciled Indian directors and a majority of Indian shareholders ; the banks to be disallowed from doing any other than banking business ; the prohibition of the organization of a bank on the managing agency system ; and the fixation of the minimum paid-up capital of a bank at Rs. 50,000.

The bringing about of the above reforms in our banking system needs co-operation and a united effort of the banks, the people and the State. All these three agencies together, if they honestly strive, can bring about the desired result and place our banking system on a sound footing and in a complete state. But much of the work of reform can be done by the Government and it is up to them to recognize their duty towards their country's material progress.

CHAPTER XXII

THE QUESTION OF A CENTRAL BANK FOR INDIA

Early Demands for a Central Bank

THE question of a Central Bank has engaged public attention for quite a long time in this country. As early as the year 1836, a body of merchants made representation to the Board of Directors of the East India Company for the establishment of such a bank in India. In the year 1859 Mr. James Wilson, the then Finance Member, wrote a minute recommending the establishment of a national banking institution on a large scale with an adequate capital. Again in 1867 Mr. Dickson, the Secretary of the Bank of Bengal, submitted detailed proposals for an amalgamation of the three Presidency Banks. The question was then discussed before the Fowler Committee in 1898, and witnesses suggested various schemes for the establishment of a Central Bank. Sir Evarard Hambro, one of the members of the Committee, specially emphasised the advantages of a Central Bank and submitted a scheme for the establishment of the same ; "the Secretary of State commended this to the careful consideration of the Government of India. In June 1901 it was proposed by Government temporarily to abandon the proposal on account of provincial and personal jealousies, and also on the score of expense, partly because it was then considered that additional capital could not profitably be employed throughout the year."[1]

In the years 1912 and 1913 the question was again the subject of hot discussion in the press and elsewhere. The Chamberlain Commission (1913) took up the matter, and asked Mr. Keynes and Sir Lionel Abrahams to prepare memoranda on the question. These gentlemen submitted their memoranda but before any action could be taken on the basis of these, the Great War broke out and the matter was deferred.

Amalgamation of the Presidency Banks

Immediately on the close of the War, the question of the amalgamation of the three Presidency Banks was taken up. This change was demanded by the banks themselves as a result of the experience gained during the War and the realisation of the desirability of strengthening and extending the banking system of the country. As we have already seen elsewhere, the Presidency Banks were amalgamated in the year 1920, and the Imperial Bank of India, under a new Act—the Imperial Bank of India Act (XLVII of 1920)—was brought into existence.

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[1] *Indian Finance and Banking*, Findley Shirras, p. 370.

The Imperial Bank

The creation of the Imperial Bank satisfied public opinion for a time, but it could not be for long, as it was evident after only a short time that the Imperial Bank as constituted could not be the substitute for a true Central Bank. It has already been seen that the Imperial Bank could not and did not perform all the functions of a Central Bank; and in spite of its creation the need of a Central Bank for India remained where it was before its creation. The matter was once again a hot bed of discussion in the press, the assembly and the platform.

Recommendation of the Hilton Young Commission

In August 1925 a Royal Commission on Indian Currency and Finance under the chairmanship of E. Hilton Young was appointed to make recommendations on the needs of Indian currency and finance. In the month of July of the following year the Commission issued their report, and explicitly and unequivocally recommended the establishment of a Central Bank with powers of issuing notes.

Dual Control of Currency and Credit

While describing the then state of affairs the Commission point out the absence co-ordination of control of currency and credit in India. "India is perhaps the only country, among the great trading countries of the world, in which the Government exercises direct control over currency in general and over the note issue in particular. The banking and currency reserves of the country are thus separated, which diminishes their capacity to effect their specific purpose of stabilisation in the most economical and efficient manner. In other countries this is effected by contracting these reserves at a Central Bank. Moreover, Government control of currency results in a dual control of monetary policy. The Government controls the currency. The credit situation is controlled, as far as it is controlled at all, by the Imperial Bank. With divided control, there is likelihood of divided counsels and failures to co-ordinate. In fact, difficulties have arisen owing to the existence of two distinct authorities controlling currency and credit. The only certain way to secure co-ordination is to concentrate the control in one hand. In other countries the single controlling hand is that of a Central Bank."[2]

Need of a Central Bank on Monetary Grounds and for Banking Stability

They further point out that a system, in which the control of currency and of credit is in the hands of two authorities, and in which the currency and banking reserves are managed and controlled separately, has great inherent weakness. Such a system cannot hope to achieve monetary stability. But besides the need of a Central Bank on monetary grounds, its need is equally great for the banking development of the country and for laying sound foundations of the credit organization. "This will only be the case if the Commercial Banks are able, when the necessity arises, to turn into cash a maximum of their assets with a minimum of disturbance to general conditions. It is only through the establishment of a Central Banking System, with the facilities of rediscounting it affords, that this end can be achieved. Not until then does the commercial banks' most legitimate asset, *viz.*, a short-term advance against goods in the form of a commercial bill, become a quick asset capable of prompt realisation in times of stress. The system in fact, enables the commercial banks to regard their holdings of commercial bills as their secondary reserves."[3]

Efficiency of Centralised Banking System

The high efficiency of a centralised banking system and its beneficial influence upon the economic progress of the countries which possess such a system is amply demonstrated by the economic history of such countries. The United States of America, which had till recently a decentralised banking system, in order to avoid monetary instability and recurring financial upheavals, had to adopt a centralised system (the Federal Reserve System) and few can deny that such a step has resulted to a very great measure in tiding over the financial difficulties of the country and in bringing her banking and currency organization to a more perfect and sound basis.

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[2] *Royal Commission on Indian Currency and Finance 1925-26 Report*, p. 9.

[3] *Ibid.*, p. 33.

Adjusts Supply of Credit

The Central Bank, which is an institution working more in the interest of the public than for its own profits, is always on its alert to adjust any discrepancies in the supply of credit. By its discount policy it always regulates the expansion and contraction of credit in the market; and in the presence of such an institution it is not possible that occasions may arise, as they do under a decentralised system, that at times there may be too much of credit offered than there is need for or at others commerce and industries may starve for want of credit.

Controls Other Banks' Activities

Such a Central Bank, which is a bankers' bank on account of its strong position and benevolent attitude towards other banks during times of stress, exercises a controlling influence on the activities of the country's entire banking system which acknowledges its allegiance to its superior strength and is guided by its policy.

Central Bank very Necessary for India

In the case of India the necessity of such a Central Bank is very great. The banking system of India is only in its infancy, it is disorganised and unco-ordinated, the people of the country have not yet inculcated the banking habit and have not the necessary confidence in the country's banking institutions; credit is dear and consequently, the commercial and industrial development of the country is being starved for want of it. In the interest of removing these shortcomings the establishment of a Central Bank is but too necessary.

Proposal for Converting the Imperial Bank into a Central Bank

As we have seen earlier, the Imperial Bank performed some of the functions of a Central Bank. It was suggested in certain quarters that instead of creating a wholly new institution the Imperial Bank should be entrusted the task of a full-fledged Central Bank. "The idea of utilising the existing organisation of the Imperial Bank is tempting at first sight, but on close consideration it will be found that, whatever advantages there may be in this course, the disadvantages outweigh them."[4]

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[4] *Royal Commission on Indian Currency and Finance 1925-26 Report*, p. 34.

Negatived by the Hilton Young Commission

The Hilton Young Commission negatived this idea on the ground that the Imperial Bank is a valuable commercial bank, its conversion into a central bank would involve a radical change in its charter, thus precluding it from much of the useful work that it is at present doing as a commercial bank. "The country would then lose the benefit of the elaborate and widespread organization which has been set up, through the length and breadth of India, to make available to the community the increased commercial banking facilities, which are so urgently needed, and to assist in fostering, among the people as a whole, the habit of banking and investment." The Imperial Bank, when a new Central Bank will be created, will be relieved of the restrictions which are imposed on its working now, and will then be more free to carry on commercial banking business.

Arguments for Converting the Imperial Bank

Sir Purshotamdas Thakurdas, one of the members of the Commission, did not concur with his colleagues, and in his minute of dissent appended to the Report, supported the idea of the evolution of the Central Bank from the existing Imperial Bank of India. Sir Purshotamdas pointed out that by raising the Imperial Bank to the status of a central bank, its commercial banking activities need not necessarily be curtailed, and even if some of them are, such a curtailment would be an impetus to the establishment of new banking institutions in the country. Besides this, in his opinion, there was no scope for two banks 'working side by side, one fully and the other partially with Government support'. He was opposed, therefore, to the multiplication of institutions supported by Government balances.

So for as the curtailment of the commercial activities of the Imperial Bank is concerned, it is undeniable that many of them will have to be curtailed if it has to be turned into a full-fledged Central Bank. A central bank which is more of a public institution than a mere profit-making organization, must be restricted in its activities, and cannot be allowed to compete with other banks of the country in their business. A central bank which competes with other banks, will always be looked upon as a rival and not as a friend, guide and philosopher, and will consequently defeat the very purpose for which it is created.

So far as the multiplication of institutions supported by Government balances is concerned, it ought to be clear that when a new central bank is created the Government balances now kept with the Imperial Bank and the Government support that it is getting at present will be transferred to the new institution, since the Imperial Bank being relieved of its present non-commercial activities, will not need them. Thus the Imperial Bank in that case will become an ordinary commercial bank; and there will be only one institution supported by Government balances and not two.

Other Reasons for Creating a New Institution

But besides the above, there are other weighty reasons for creating an entirely new central bank and not converting the Imperial Bank into a Central Bank. As has already been pointed out in an earlier chapter, the Imperial Bank's directorate and management are preponderatingly non-Indian.

Non-Indian Outlook of the Imperial Bank

An institution with a non-Indian directorate and management may not always have a national outlook, and particularly at times when the interests of their country may come in clash with those of India. Such an attitude has been evidenced by the present Imperial Bank and its predecessors, the Presidency Banks. They have not always shown sympathy for the advancement of national banking and in times of stress assistance to Indian banks has been refused by them even against Government securities and they have not always advanced the same credit facilities to Indians as they offered to non-Indians. A central bank evolved out of the Imperial Bank will naturally inherit some of its old traditions, which will always hamper the loftiness of the mission and the broad and impartial outlook of a Bank of Issue. Neither is such an institution expected to infuse that confidence and sense of respect among the other banks, which a bankers' bank should infuse. The central bank should be a purely national institution with national capital, national directorate and national management. Such an institution can only be a newly created bank.

Liquidation of Accounts

Again, as Mr. Thakore says in his *Organization of Indian Banking*, the transformation of the Imperial Bank would require a strict examination and valuation of all its assets, and certain accounts on its books may be such as cannot be carried forward to the books of a central bank. This would involve the liquidation of these accounts, which may mean not only a financial disaster to the parties concerned but also a great disturbance in the money market. Besides this the Imperial Bank has hitherto been doing a good deal of commercial banking business with the principal object of making profits for its shareholders.

Imperial Bank accustomed to Earning High Profits

A central bank cannot earn high profits, and a part of its profits go to the State. The shareholders of the Imperial Bank who have been getting high dividends may not agree to this. A new bank, with no past accounts, with no past traditions, and with new shareholders, which will have from the outset a free hand in moulding the shape of its assets according to its constitution, and in evolving an outlook and policy which suit a central bank, will be a much better institution than the transformed Imperial Bank.

State Bank or Shareholders' Bank

After having arrived at the decision in favour of the creation of an entirely new central bank, the next question which arises, and which has given rise to much controversy in Indian public opinion is whether such a bank should be a State bank or a private institution with State supervision.

Government Control

There are not, however, two opinions concerning State supervision and control of such an institution. A central bank being first a national bank and then a profit-making organization, should be controlled and supervised by the State in order that it may work in the interest of the country and not merely in that of its shareholders. Because the Government entrust it with their funds and confer upon it the privilege of issuing notes, the State is justified in having a controlling hand over the bank. And since the stability of the whole banking organization of the country depends on that of the central bank, it should be the business of the Government to see that it does not indulge in business which is risky or hazardous.

Arguments for a Private Bank

The bulk of the expert opinion is in favour of a private bank, and the example of the central banks of other countries also favours this view. In almost all the important countries the central banks are privately owned and privately managed, subject to State supervision.

State Unfit to Conduct Credit and Currency Business

The business of dealing in credit and currency is a very delicate one. It can be carried on efficiently on strict business principles. The State machinery is not fit to conduct such a business. Moreover, State officials cannot be interested so much in the welfare of the bank, as managers and directors of private banks can be. State officials with too much stability of service and pay, and with a fixed annual increment irrespective of their work and efficiency, can hardly exercise much initiative. Their work is generally of a routine character, which is not suited to the business of a bank.

Party Politics

Modern States are conducted on party principles. With a change in the power of the parties, the Government of the country changes. Such changes in political parties will always be likely to change the policy and working of a State Bank, and it will be run more in the interest of the party in power than in the interest of the nation as a whole. A bank of issue should be free from all influences ; party politics should be foreign to its management.

Indian Government Alien

In the case of India the reasons against a State Bank become even more marked. The State in India at present is a foreign one, which, in the past, had not shown much sympathy with and response to Indian sentiment and public opinion, and the interest of which have as well not always been identical with those of the country. A central bank managed and owned by such a Government may not be worthy of being called a national institution.

Officialism Slow and Irresponsible in India

Officialism in India is extremely slow and mostly irresponsible. Indian Government officers have never considered themselves as servants of the people, but on the contrary they think they are masters. A bank conducted by such men will be like other Government departments, not worked in the interest of the people but in that of an alien Government. Public opinion has no weight with these officers, and the State is ever anxious to defend them. With these conditions a bank worked by such men can hardly attain necessary efficiency in its working.

Communal Representation

The Indian Government follows the principle of communal representation and communal distribution of offices.

These cannot suit a bank. In a bank it should be only efficiency which should form the basis of appointments. A State bank, managed by a Government believing in communal representation, may be demanded to distribute even credit on communal basis.

Capitalist Control can be Avoided

The fear, that a private bank will fall under capitalist control, and on account of its strong position will be a menace to the growth of indigenous banks, can be set aside if the shares of the new bank are of small value, say Rs. 100 each, so that they may be in the reach of small subscribers, ensuring a wide distribution of shares in Indian hands. Besides this the dividend on these shares being fixed, and with the strict limitation of voting power of large shareholders, there will be no danger of the bank competing against other banks and also of falling under capitalist control.

Constitution as recommended by the Hilton Young Commission

As regards the constitution of the management of the central bank (Reserve Bank), the Hilton Young Commission recommended the adoption of the system of the existing Imperial Bank. "The system of the local head offices in the chief business centres, managed by local boards, who are elected by the shareholders registered in the respective branch registers, appears to us to be as appropriate to the organization of the Reserve Bank as it is to that of the Imperial Bank."[5] The Central Board, according to the Commission, should consist of 14 members ; the Presidents and Vice-Presidents of the Local Boards and one elected member from each Local Board, a Managing Governor and a Deputy Managing Governor appointed by the Governor-General-in-Council, and three non-official members nominated by the Governor-General-in-Council. The Commission claim that such constitution will leave the Reserve Bank free from day-to-day interference of the executive and at the same time, ensure the desired Government control over the Bank's policy.

Capital

The Commission opined that a fully paid-up capital of Rs. 5 crores was sufficient for the Reserve Bank, as a greater capital may lead the Bank to do risky business in order to earn greater profits. This share capital was to be offered to the public for subscription, each share being of the value of Rs. 500, and the shareholders of the Imperial Bank to be given the first chance of subscribing to it. In order to guard against the danger of a group of shareholders acquiring control of the affairs of the Bank, the voting power of the shareholders is to be restricted; each shareholder to have one vote for each four shares held and no shareholder to have more than a total of ten votes. Since the Reserve Bank would not be merely a profit-earning bank, the maximum dividend on the shares to be limited to 8 per cent.

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[5] *Royal Commission on Indian Currency and Finance 1925-26 Report*, p. 37.

Proposal of the Government of India re. Constitution

The proposal of the Government of India regarding the constitution of the Reserve Bank was a slight improvement upon the Commission's recommendations. When the Reserve Bank Bill was being discussed in the Assembly in August 1927, Sir Basil Blackett, the then Finance Member, said that the Government were in full agreement that it was desirable that the board (of directorate) should be predominantly Indian, while not excluding altogether that co-operation of Europeans with Indians which, all agree, was desirable. The Government had dropped the proposal that some preference in the allotment of shares in the Reserve Bank be given to the shareholders of the Imperial Bank. The nominal value of shares was reduced from Rs. 500 to Rs. 100 and preference was to be given to small subscribers domiciled or ordinarily resident in India. Further they had fixed the dividend at 6 per cent. cumulative instead of allowing it to rise to 8 per cent. A gilt-edged investment offered in shares of Rs. 100 each at 6 per cent. at par would be within the reach of small subscribers ensuring a wide distribution of shares in Indian hands. The strict limitation of the voting power of large shareholders would prevent the bank from falling under capitalist control.

As regards the constitution of the directorate the Government proposed the election of nine directors by the shareholders under a system of single transferable vote, thereby ensuring the representation of a wide variety of opinion and interest among the shareholders. An opportunity was given of electing a director apiece to the Federation of Indian Chambers of Commerce and the provincial co-operative banks. The director chosen by the latter would specially represent agriculture while with three directors nominated by the Government, there would be ample opportunity for seeing that agriculture was not under-represented and that interests, localities and communities that might otherwise be left out shall not go unrepresented.

Such a constituted Reserve Bank would have been a central bank with powers of note issue, and would have acted as a banker to the Government and a bankers' bank. It would have worked as agent to the Government in their financial and currency matters, would have rediscounted commercial bills, would have kept bankers' balances and controlled the money market through its bank rate.

The Scheme was Dropped

But such a useful institution was not to come yet. The question of the Reserve Bank was brought before the Legislative Assembly for discussion in the Simla Session in August 1927. The bill incorporated the scheme of a State Bank, but no agreement could be reached on the question of directorate. The Government sustained a defeat in their attempt to exclude a member of the Legislature from being a director. The bill was then withdrawn by the Government; and the next year they brought a new bill which favoured the idea of a shareholders' bank. This new bill was not allowed to be moved by the President on the ground of procedure. The Government thereupon decided to proceed with the old bill. With this decision all the old troubles revived and the Government found the opposition too strong for their proposal regarding the constitution of the board. The Assembly still insisted upon the inclusion of members of the Assembly in the directorate, and to this the Government was opposed. Since no compromise could be arrived at, the Government postponed the idea of proceeding with the bill. And thus the question of a Central Bank for India was postponed *sine die*.

Recommendations of the Central Banking Enquiry Committee

The Indian Central Banking Enquiry Committee of 1931 have very strongly recommended the earliest establishment of a central bank in India. "We accordingly consider it to be a matter of supreme importance from the point of view of the development of banking facilities in India, and of her economic advancement generally, that a Central or Reserve Bank should be created at the earliest possible date. The establishment of such a bank would, by mobilisation of the banking and currency reserves of India in one hand, tend to increase the volume of credit available for trade, industry and agriculture and mitigate the evils of fluctuating and high charges for the use of such credit caused by seasonal stringency."[6] They, however, recommend a few amendments in the Reserve Bank Bill of 1928, in the light of both improving the bill and making it consistent with their own recommendations on Indian banking in general. Some of the amendments proposed are that the Reserve Bank should be empowered to purchase, sell and rediscount rupee import bills (the introduction of which is recommended by the Committee) which shall be drawn outside India;[7] that the period of six months of such agricultural bills as will be discounted by the bank should be extended to nine months since they think that seasonal operations in India extend over a longer period than six months ; and that the bank should be allowed when necessary to act as agent for an Indian State just as it would act for the Secretary of State or the Government of India or any local government.

As regards the policy of the Reserve Bank, they lay stress on the fact that from the very inception of the bank it should have a national outlook and a very sympathetic attitude towards the other banks of the country, so that it may be able to win their confidence and thereby may be able to effectively guide them and control their activities. They recommend, therefore, that for the successful working of the bank, it should be worked and managed by first class men and should be free from any interference in its work from the Government or any outside agency. They think, "that a Reserve Bank can be run on sound lines whether it is formed as a State Bank or as a shareholders' bank, provided that the Bank is kept free from the interference by the Government in its daily administration."

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[6] *Indian Central Banking Enquiry Committee Report*, p. 417.

[7] The Bill of 1928 provides the purchase and sale by the Reserve Bank of bills drawn and accepted in India.

CHAPTER XXIII

THE RESERVE BANK OF INDIA

What Led to its Establishment

THE question of a Central Bank for India (the Reserve Bank) was again taken up in the Round Table Conferences. In the First Round Table Conference the Federal Structure Sub-Committee recommended that 'with a view to ensuring confidence in the management of Indian credit and currency, efforts should be made to establish on sure foundations and free from any political influence, as early as may be found possible, a Reserve Bank which will be entrusted with the management of currency and exchange'. In the third Round Table Conference the Financial Safeguards Committee made the establishment and proper functioning of a Reserve Bank of India an essential preliminary to the introduction of the scheme of Reforms to give India a Federal Government. The Committee said, "that the proposals to be submitted to Parliament should be based on the assumption that such a Reserve Bank would have been created prior to the inauguration of a federal constitution, and recommended that steps should be taken to introduce into the Indian Legislature a Reserve Bank Bill conceived on the above lines as soon as possible". The Committee further said that 'the Secretary of State undertook that representatives of Indian opinion would be consulted in the preparation of the proposals for the establishment of the Reserve Bank including those relating to reserves'.

In response to the above undertaking the Reserve Bank Committee was appointed and on the strength of its recommendations the Reserve Bank Bill was introduced in the Legislative Assembly on September 8, 1933. The Bill was passed by the Legislative Assembly and Council of State and received the assent of the Governor-General on March 6, 1934. Thus after all the Reserve Bank of India came into existence.

Question of Monetary Standard Undecided

As the preamble to the Reserve Bank of India Act points out the Reserve Bank was constituted to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in British India and generally to operate the currency and credit systems of the country to its advantage. But the question of determining a suitable permanent basis for the Indian monetary system was still left undecided. It was pointed out that 'it is expedient to make temporary provision on the basis of the existing monetary system, and to leave the question of the monetary standard best suited to India to be considered when the international monetary position has become sufficiently clear and stable to make it possible to frame permanent measures'.

Share Capital

The Reserve Bank was started with a Share Capital of five crores of rupees divided into shares of one hundred rupees each, fully paid up. With a view to bring about an even distribution of shares throughout the country separate registers of shareholders are maintained at Bombay, Calcutta, Delhi, Madras and Rangoon. The nominal value of the shares originally assigned to the various registers was as follows :—Bombay register 144 lakhs of rupees, Calcutta register 145 lakhs of rupees, Delhi register 115 lakhs of rupees, Madras register 75 lakhs of rupees and Rangoon register 30 lakhs of rupees. A shareholder was qualified to be registered as such in any area in which he was resident or had his principal place of business but no person could be registered as a shareholder in more than one register. According to the Act only Indians or those domiciled in India could be shareholders or those British subjects who were ordinarily residents in India and domiciled in the United Kingdom or in any part of His Majesty's Dominions the Government of which does not discriminate in any way against Indian subjects of His Majesty. Again having regard to the desirability of distributing the shares and the voting rights attached to them as widely as possible the Act provided that as far as possible individuals may not possess more than five shares each and preference may be given to applicants applying for five or less than five shares.

CONSTITUTION OF THE BANK

Central Board

The general superintendence and direction of the affairs and business of the Bank is entrusted to a Central Board of Directors which according to the Act consists of sixteen directors as below :

(*a*) A Governor and two Deputy Governors, to be appointed by the Governor-General-in-Council after consideration of the recommendations made by the Board in that behalf.

(*b*) Four directors to be nominated by the Governor-General-in-Council.

(*c*) Eight directors to be elected on behalf of the shareholders on the various registers (two each for the Bombay, Calcutta and Delhi registers and one each for the Madras and Rangoon registers).

(*d*) One Government official to be nominated by the Governor-General-in-Council.

The Governor and Deputy Governors to be whole time paid men and to be appointed for a maximum term of five years, but could be reappointed on the expiry of their terms.

The Government official nominated by the Governor-General-in-Council and a Deputy Governor can attend any meeting of the Central Board and take part in its deliberations but are not entitled to vote.

Local Boards

Besides the Central Board there are separate Local Boards for each of the five areas represented by the separate registers of shareholders, and these consist of :—(*a*) five members elected from amongst themselves by the shareholders who are registered on the register of that area ; and (*b*) not more than three members nominated by the Central Board from amongst the shareholders registered on the register for that area. The function of the local boards is more or less advisory. They are expected to advise the Central Board on matters which are referred to them and to perform such duties as the Central Board may delegate to them.

BUSINESS OF THE BANK

According to the Act the Bank is authorized to carry on and transact the following kinds of business :—

Deposits

(1) the accepting of money on deposit without interest from, and the collection of money for, the Secretary of State, the Governor-General, Local Governments, Indian States, local authorities, banks and any other persons ;

Discounting and Rediscounting

(2) the purchase, sale and rediscount of bills of exchange and promissory notes, drawn and payable in India and arising out of *bona fide* commercial or trade transactions bearing two or more good signatures, one of which

shall be that of a scheduled bank, and maturing within ninety days from the date of purchase or rediscount; or bills and promissory notes drawn to finance seasonal agricultural operations and the marketing of crops and maturing within nine months; or commercial paper bearing the signature of a scheduled bank and issued for the trading in the securities of the Government of India, or of Local Governments, or of certain States and maturing within ninety days;

Sale or Purchase of Sterling and Treasury Bills

(3) the purchase from and sale to scheduled banks of sterling in amounts of not less than the equivalent of one lakh of rupees; or the purchase, sale and rediscount of bills (including treasury bills) drawn in the United Kingdom and maturing within ninety days, provided that no such purchase, sale or discount shall be made in India except with a scheduled bank; and the keeping of balances with banks in the United Kingdom;

Loans and Advances

(4) the making of loans and advances for a period not exceeding ninety days to States in India, local authorities, scheduled banks and provincial co-operative banks against the security of trusty stock, gold, silver, documents of title, and such bills of exchange and promissory notes as are eligible for purchase or rediscount by the Bank; and the making of advances to the Governor-General and to local Governments for a period of not more than three months;

Drafts

(5) the issue of demand drafts payable at its own offices or agencies;

Purchase and Sale of Securities

(6) the purchase and sale of Government securities of the United Kingdom maturing within ten years from the date of purchase and the purchase and sale of securities of the Government of India or of a local Government of any maturity provided the total value of securities does not exceed the amount of the share capital of the bank, the Reserve Fund and a certain proportion of the liabilities of the Banking Department of the Bank;

Agency Business

(7) the acting as agent for the Secretary of State, the Governor-General, local Governments and local authorities for the purposes of purchase and sale of gold or silver, the

purchase, sale, transfer and custody of bills, securities or shares, the collection of interest and dividends, the remittance of proceeds by bills and the management of the public debt ;

Borrowings

(8) the borrowing of money for not more than one month for the business of the Bank either from scheduled banks in India or from central banks in other countries provided the total amounts of such borrowing in India shall not exceed the amount of the share capital of the Bank ; and

Bank Notes

(9) the making and issue of bank notes.

Open Market Operations

The Act further provides that on special occasions if the Central Board thinks that it is necessary or expedient to take direct action for the purpose of regulating credit in the interests of Indian trade, commerce, agriculture and industry, the Bank may (*a*) purchase, sell or discount bills of exchange or promissory notes though they may not bear the signature of a scheduled bank or a provincial co-operative bank, (*b*) purchase and sell sterling in amounts of not less than the equivalent of one lakh of rupees, and (*c*) make loans or advances repayable on demand or on the expiry of the fixed period, not exceeding ninety days against certain forms of security as mentioned in Clause (4) of Section 17 of the Act.

CENTRAL BANKING FUNCTIONS

Banker to the Government

It is the business of the Reserve Bank to accept money for account of the Secretary of State, the Governor-General and the local Governments and to make payments for them and to carry out their exchange, remittance, and other banking business, including the management of the public debt.

The Central Government and the Provincial Governments have to entrust the Bank with all their money, remittance, exchange and banking business in India and to deposit free of interest all their cash balances with the Bank.

The Bank is also to undertake the management of the public debt and the issue of any new loans for the above authorities on conditions that may be agreed upon.

Currency Authority

The Reserve Bank has the sole right to issue bank notes in British India and the Government currency notes which are supplied to it by the Governor-General-in-Council. The notes issued by the bank are legal tender throughout British India. The period for which the Bank may control currency is, however, to be determined by the Governor-General-in-Council on the recommendation of the Central Board, but the Governor-General-in-Council can supersede the Central Board in this matter and can entrust the work to some other agency if the Bank fails to carry out its obligations.

Issue and Banking Departments

According to the Act, notes issued by the Bank shall be of a denominational value of five, ten, fifty, one hundred, five hundred, one thousand and ten thousand rupees. And the issue of these shall be conducted by the Bank in an issue department which shall be separated and kept wholly distinct from the banking department. The business of the issue department will be that of a pure bank of issue and it will be entirely distinct from the banking department so much so that the assets of the issue department shall not be subject to any liability other than the liability of the issue department. On the same ground the issue department shall not issue bank notes to the banking department except in exchange for other bank notes or coins, bullion or securities.

Assets of the Issue Department

The assets of the Issue Department should be equal in value to its liabilities and should consist of gold coin, gold bullion, sterling securities, rupee coins and rupee securities. Of the total amount of assets at least two-fifths should consist of gold coin, gold bullion or sterling securities, provided the amount of gold coin and gold bullion is at no time less than forty crores of rupees in value. The remaining assets can be held in rupee coin, Government of India rupee securities and bills of exchange and promissory notes payable in British India as are eligible for purchase by the Bank, provided the amount held in rupee securities does not exceed one-fourth of the total assets or fifty crores of rupees, whichever is greater.

Liabilities of the Issue Department

The liabilities of the Issue Department should be equal to the value of the currency notes of the Government of

India and the Bank notes for the time being in circulation. The liability for all the currency notes of the Indian Government under circulation is to be taken over by the Bank from the Governor-General-in-Council. In exchange for this liability the gold coin, gold bullion, sterling securities, rupee coin and rupee securities equal in value to the liability are transferred to the Issue Department and also the whole of the Gold Standard Reserve and the Paper Currency Reserve.

Bankers' Bank

Every scheduled bank[1] in India has to maintain with the Reserve Bank a balance, the amount of which is not, at the close of business on any day, less than five per cent. of the demand liabilities and two per cent. of the time liabilities of such bank in India. Every scheduled bank is required to submit each Friday to the Governor-General and to the Reserve Bank a return showing the amounts of its demand and time liabilities, the total amount held in currency notes and Bank notes, the amount held in coins, the amounts of advances made and bills discounted and the balance held at the Bank.

If the balance held with the Bank is below the minimum prescribed the scheduled bank has to pay to the Reserve Bank for each day interest at 3 per cent. above the Bank Rate on the amount by which the balance with the Bank falls short of the prescribed minimum and if, on the day of the next return, the balance is still below the prescribed minimum, the rate of penal interest is to increase to 5 per cent.

As against the above restrictions on the activities of the scheduled banks, the Reserve Bank is expected to help these banks whenever they may be in trouble. Not only does the Reserve Bank provide them with re-discounting facilities but can advance them loans. We have seen above that the Reserve Bank can ordinarily discount bills or promissory notes which bear the signatures of a scheduled bank or a provincial co-operative bank. And also that it can advance loans to these alone besides those to Governments.

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[1] Scheduled banks are banks in India included in the second schedule of the Bank Act. Banks having paid-up capital and reserve of not less than five lakhs of rupees and which are incorporated as a company or corporation are eligible to be included in the list of scheduled banks. A scheduled bank, the paid-up capital and reserve of which falls below five lakhs of rupees can be excluded from the list of scheduled banks by the Governor-General-in-Council.

Agricultural Credit Department

According to the Act, the Bank was required to create a special Agricultural Credit Department for the purpose of maintaining an expert staff to study all questions of agricultural credit and which will be available for consultation by the Central Government, local Governments, provincial co-operative banks, and other banking organisations. Such a department is further expected to co-ordinate the operations of the Bank in connection with agricultural credit and its relations with provincial co-operative banks and any other banks or organisations engaged in the business of agricultural credit.

Obligation to Sell or Buy Sterling

With the taking over of the currency functions from the Governments and for the purpose of maintaining exchange it has become obligatory on the Bank to sell to or buy from any person who makes a demand at its office in Bombay, Calcutta, Delhi, Madras or Rangoon, sterling for immediate delivery in London at a rate not lower than 1*s*. $5\frac{49}{64}$ *d*. and not higher than 1*s*. $6\frac{3}{16}$ *d*. respectively, but the Bank will not buy or sell an amount of sterling less han ten thousand pounds.

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Forbidden Business

The Bank is not allowed to (1) have a direct interest in any commercial or industrial undertaking except when it is necessary to satisfy its claim, (2) purchase its own shares or those of any other bank or company, (3) advance money on the security of immovable property, (4) make loans or advances, (5) draw or accept bills payable otherwise than on demand, and (6) allow interest on deposits or current accounts.

Agreement with the Imperial Bank

To avoid the necessity of opening various branches in India and in order to utilise the Imperial Bank and its many branches, the Reserve Bank has entered into an agreement with the Imperial Bank for a period of fifteen years and thereafter until terminated after five years' notice on either side. This agreement is conditional on the maintenance of a sound financial position by the Imperial Bank and its carrying out of the conditions of the agreement to the satisfaction of the Governor-General-in-Council and the Central Board.

According to the agreement, the Imperial Bank is the sole agent of the Reserve Bank at all places in British India where the Imperial Bank has a branch and where there is no branch of the Banking Department of the Reserve Bank. In consideration of this service, the Reserve Bank pays remuneration to the Imperial Bank.[2]

Besides this, the Reserve Bank is to pay the following sums to the Imperial Bank in consideration of the maintenance by the Imperial Bank of all its branches which were in existence at the time of the agreement:—Nine lakhs of rupees per year during the first five years, six lakhs during the next five years and four lakhs during the next five years.

London Branch

The Bank has opened a Branch in London simultaneously with the commencement of its business in India. It is thought that the London Branch will do more economically the work in connection with Home Charges and other operations of the Reserve Bank, and thus cause a great saving in commission and other charges which would otherwise have to be paid to England, and would also provide valuable opportunities to Indians to get training and experience in banking by coming in contact with international banking experts.

Bank Rate and Bank Return

It is obligatory on the Reserve Bank to publish from time to time the standard rate at which it is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under the Act. It has also to publish weekly in the prescribed form the accounts of both the Issue and Banking Departments in the *Gazette of India*. The following is a specimen of the statement of affairs of the Reserve Bank of India for the week ending April 2, 1937:—

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[2] The rate of remuneration during the first ten years is fixed at 1/16th of 1% on the first 250 crores and 1/32nd of 1% on the remainder of the receipets and disbursements. After ten years the remuneration is to be equal to the actual cost to the Imperial Bank.

ISSUE DEPARTMENT

LIABILITIES		ASSETS	
	Rs.		Rs.
Notes held in the Banking Department ..	13,93,26,000	A. Gold Coin and Bullion—	
Notes in circulation—		(*a*) Held in India	41,55,19,000
(*a*) Legal Tender in India	193,73,29 000	(*b*) Held outside India	2,86,98,000
(*b*) Legal tender in Burma	20,09,000	Sterling Securities	79,30,70,000
Total Notes issued ..	207,86,64,000	Total of A ..	123,72,87,000
		B. Rupee Coin	61,76,15,000
		Government of India Rupee Securities ..	22,37,62,000
		Internal Bills of exchange and other Commercial paper	Nil
Total Liabilities ..	207,86,64,000	Total Assets ..	207,86,64,000

Ratio of total of A to Liabilities 59·52 per cent.

BANKING DEPARTMENT

LIABILITIES		ASSETS	
	Rs.		Rs.
Capital paid up	5,00,00,000	Notes—	
Reserve Fund	5,00,00,000	(a) Legal Tender in India	13,92,21,000
		(b) Legal Tender in Burma only	1,05,000
Deposits—		Rupee coin	4,76,000
(a) Govern ment*	13,63,09,000	Bills discounted—	
(b) Banks	23,03,37,000		
(c) Others	53,12,000	(d) Internal	Nil
Bills Payable	12,21,000	(b) External	Nil
		(c) Government Treasury Bills	Nil
Other Liabilities	41,69,000	Balances held abroad†	25,60,07,000
		Loans and Advances to the Government	Nil
		Other Loans and Advances	1,10,000
		Investments	7,75 92,000
		Other Assets	35,67,000
Total Liabilities	47,73,48,000	Total Assets	47,73,48,000

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* Includes £1,40,000 held in London.

† Includes Cash and Short-Term Securities.

Aims of a Central Bank

It is yet early to say whether the Reserve Bank of India is operating successfully or not and whether it has been able to realise the objects for which it has been created. Some essential objects, to realise which a Reserve Bank is created, are to stabilise the banking system of a country, to stabilise and improve the currency and to be instrumental in creating a greater supply of capital and credit for the harmonious development and expansion of a country's varied economic activities. In order to realise these ends it creates a centralised reserve system, affords rediscounting facilities, acts as the currency authority and controls and helps the activities of various banking institutions for giving them the right lead in financing commerce, industries and agriculture.

What the Reserve Bank can do

The Reserve Bank of India as constituted has been handed over the currency function, it keeps part of the balances of the scheduled banks and in return offers rediscounting facilities and can advance loans to them and to co-operative banks, it is allowed to carry on open market operations, is under obligation to sell and buy sterling and has an agricultural credit department. All these are important activities for the realisation of the aims of a Reserve Bank. Currency controlled and issued by it is more elastic and stable in value and consequently more efficient. The creation of a centralised reserve system, the provision of rediscounting facilities and loans to banks, and the excercise of control over their activities, essentially lead to making the banking system more efficient and consequently one in which people have greater confidence, without which it can neither be popular nor extensive nor can develop the money power of and investment habit in the people that it serves. Its free purchase and sale of sterling or of gold will essentially lead to the stability of exchange and the stability and development of foreign trade. Its open market operations will make effective the Bank's policy with regard to expansion and contraction of credit. The direct-discounting of bills and the purchase of Government securities can be effective in breaking down excessive interest rates and the sale of securities and commercial paper will contract credit and check excessive speculation. The provision for rediscounting facilities to provincial co-operative banks and for loans to them and the creation of the agricultural credit department of the Bank should be intrumental in the development of co-operative credit and agriculture.

Where it Fails

The Bank even as it is constituted, can, therefore, do a great deal in the direction of the economic development of the country, but much will depend on its management and outlook from the very beginning. A satisfactory conduct of the day-to-day business of the Bank based on a broad national policy will go a long way in its being able to justify its creation and existence. This does not, however, mean that the constitution of the Reserve Bank is perfect and that it could not have been better. In fact, many important considerations have been neglected, with the inclusion of which the bank would have been far more useful than it is or will be. But besides this neglect, the beginning which the Reserve Bank has made in the direction of its relations with other banks, its management and appointments and its outlook are not very hopeful auguries of a very bright future.

Political Influence

One thing which is essential in the interest of the proper and useful working of a Reserve Bank is its complete freedom from any political influence. No one, of course, can deny the necessity of a certain amount of Government control upon the activities of such a bank ; that is necessary in the interest of safety. But Government control and political influence are two things. In the case of the Reserve Bank of India there is not so much of Government control as political control. The resting of the final word with the Governor-General and not with the Federal Government justifies this accusation. The Governor-General is bound to act under the orders of the Secretary of State for India, who is a representative of a political group of England. The Bank thus virtually comes under the control of an English political group and not under that of the Government of its own country. The effects of such a political influence are obvious and under it the Bank has made the start.

Favour to Imperial Bank

Another initial mistake has been the favour shown to the Imperial Bank. The entrusting of the sole agency business to the Imperial Bank and the payments to it by the Reserve Bank particularly after the removal of the restrictions on the activities of the Imperial Bank are not only unfair to other banks of the country but also hit them hard for now the Imperial Bank will be able to compete with other banks with the help of their own money (kept as reserve with the Reserve Bank). The agency business also could have gone to a bank after inviting tenders from all the banks on the approved list for competitive terms. This would have proved both fair and more economical.

Exchange Banks

Again, the question of any effective control on the activities of the exchange banks and proper restriction on their business in order to encourage indigenous enterprise in this field and to remove the baneful effects of their policy on Indian foreign trade is left undecided by the Reserve Bank Act. The Exchange Banks retain the same advantages as before in competing against the country's banks; the Reserve Bank can hardly exercise any control or influence on them, for they can obtain practically unlimited finance from their Head Offices and may keep the rates of interest high, for the power of the Reserve Bank to discount bills directly has no connection with the foreign trade business.

Agricultural Finance

The Reserve Bank Act does provide for rediscount of agricultural paper and, for taking such paper as security against loans and advances, and for the creation of an agricultural credit department. These provisions, no doubt, can go far in the progress and development of agricultural finance but the Reserve Bank Act has totally neglected the Indigenous Bankers. It is a very well-known fact that by far the greatest part of agricultural credit is actually financed by indigenous bankers, and the indigenous bankers occupy a very important place in Indian economic life. Much of the question of agricultural finance can be solved by merely improving the methods of the indigenous bankers and by making them more useful. This could be achieved to a large extent by linking up the indigenous bankers with the Reserve Bank and by having carried out the recommendations of the Central Banking Enquiry Committee in this connection. To have ignored this important side of rural credit is to leave unsolved an important part of the problem of agricultural finance.

Industrial Finance

As regards industries, the Reserve Bank can only provide short-term accommodation to promote industrial finance by means of loans that it can grant against the security of promissory notes drawn against cash credits. It cannot in any way provide initial capital to industries nor can it in anyway help their flotation and extension. Central Banks in other countries take up this important business and even in England, where there is no scarcity of industrial finance and investing public, the Bank of England has gone further, than central banking practice usually would go, in connection with the Securities Management Trust and the Bankers' Industrial Development Company. There does not seem to be any plausible reason why the Reserve Bank of India could not have included this in its business, particularly when India is industrially so backward and when every possible means is necessary to develop her industries.

Chapter XXIV

BARTER AND EXCHANGE

Self-sufficiency ; Domestic Life and Dependence

The most primitive savage had only a very few wants—for water and food in the first instance, and for a little clothing and a crude shelter later on. These wants he satisfied directly with his own efforts. Water he drank from the nearest stream whenever he was thirsty, for food either he picked the fruits of the wild trees around him or killed some wild animal ; the shade of the trees and the dens of the wild animals whom he could drive away, or the natural caves provided him with shelter ; and the bark and leaves of trees he used for his clothing. But man by nature is a social animal. He could not go on living in this solitary way for long and consequently, he began to associate with other human beings, either of his own sex or of the other sex. This association resulted in the creation of domestic life on the one hand, and a mutual dependence for the satisfaction of wants on the other. The man went out in search of food for himself and his mate, while the woman at home tried to shape the bark and leaves of trees into better forms of apparel, both for herself and for the man.

Division of Labour and Exchange

The first result which such an association brought about was division of labour, which could be possible on account of and which naturally resulted in exchange. The man could confine his activities only to the production of food, because he was sure of getting clothes in exchange for the extra food that he produced, and the woman could occupy herself with producing clothes in the hope of getting food in exchange for the extra clothing that she produced. Thus division of labour gave rise to exchange and it could itself not be possible without exchange. Both are, therefore, dependent upon each other and are the cause and effect of each other. The development of one led to the growth of the other and *vice versa*. And as civilisation grew and more men came into contact with one another, there grew a greater mutual dependence and greater division of labour and more of exchange. Exchange from its inter-domestic nature grew to be local and then inter-tribal. As the nomadic tribes became more and more settled and took to agriculture, or some other definite economic occupation, and their size grew, division of labour became more necessary. With the growth in the size of the community, there could be found enough work of a particular kind to employ one man's whole time in making that thing for the community. Some members of the community took up the profession of agriculture, while others those of shoe-makers or weavers or potters or smiths. And again, as the unit of society grew, a village developed into a town and a town into a nation; exchange became more and more wide and with the development in the means of communication it became ultimately world wide. Thus we find to-day that in all economically advanced countries almost every one produces for exchange, "and the complexities of exchange have increased as fast as the development of specialisation and the growth of division of labour."[1]

Barter and its Inconveniences; Scarcity of Double Coincidence

Exchange, in its literal sense, means the exchange of one commodity for another commodity directly; this, in economic terminology, is called *barter*. Exchange, in economic sense, means double barter or the exchange of a commodity for *money*. It is said that barter is inconvenient; and it is a fact too, for barter limits exchange to a great extent. The chief defect of barter is the want of coincidence in it. It is difficult to always find two persons who want to dispose of things which each of them wants. A man having a pair of shoes to offer may want a cap in exchange, but one who has a cap to offer may not want a pair of shoes but may be wanting a shirt instead, and one having a shirt may not want either. In order, therefore, that barter may be successful, "there must be a *double coincidence*,"[2] and such a double coincidence is rare.

Different Values of Things

The second difficulty in barter arises on account of the different values of different things for exchange. If all things were of the same value, each could be exchanged for the other. But in reality it is not so; a cow cannot be of the same value as a calf, nor a house as a post card. How are these things to be exchanged then? They could be exchanged if they could be divided and subdivided without impairing their values. But all things cannot be divided. A horse cannot be divided into two in order to exchange half of it for a donkey, nor can a shirt or coat or a cap be split up into two or more parts without either making it altogether useless or reducing its value to a great extent.

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[1] *The Mechanism of Exchange,* Todd, p. 8.

[2] *Money,* Jevons, p. 3.

All Men may not Want to Exchange at the Same Time

Besides these two there is a third difficulty also. All men do not want to exchange their things at the same time. A man who has a horse to offer in exchange for a cow, may find a man with the cow, but the man with the cow may not want to part with it just now, though he may want to exchange it for a horse after a month. The result of all these difficulties was that exchange was limited to a few commodities and could not be wide; this placed a check upon division of labour which, in turn, limited production.

Double Barter better than Single

Men were, therefore, always striving to do away with these difficulties of barter. These could be done away with only when a double coincidence instead of being rare, could be made common; some means could be devised by which the commodities to be exchanged could be divided without a change in their value; all men who possessed exchangeable commodities could be induced to exchange them at one time; and the exchanges could be simplified. Men were not late in finding out a way to bring about the above conditions. They found that instead of single barter, double barter is better, that it does away with all the inconveniences of barter. Single barter or barter is the exchange of one commodity for another directy; while double barter or

Exchange

exchange is the splitting up of the process into two transactions. Instead of exchanging the thing directly with the other, it has to be exchanged first with a commodity of wide acceptance and then this commodity of wide acceptance is exchanged for the other commodity which is wanted. The introduction of this commodity of wider acceptance breaks up the single act of barter into two separate acts of barter, that of sale and purchase. The name given to this commodity of wide acceptance, which acts as an intermediary article, is *Money*.

CHAPTER XXV

MONEY AND ITS FUNCTIONS

Money and its Functions

It will not be very convenient to define money before we have seen the functions of money ; for money is known by its functions, or in other words, money is what money does. Money in the main, removes the inconveniences of barter, and this it does by its various functions. We will, therefore, first see the functions of money.

The functions of money are four :—

Medium of Exchange

(1) Money acts as a means or medium of exchange, *i.e.*, it acts as a universal third commodity for which all goods are exchanged. By this function of its, it does away with the first difficulty of barter ; of the rarity of a double coincidence. A man with a horse and wanting a cow instead, feels no difficulty in disposing it of for money to those who want a horse, and with the money so obtained he can purchase a cow.

Common Measure of Value

(2) Money is a common measure of value. Since everything is exchanged for money, it becomes the common measure or denominator of value. Everything has its value expressed in terms of money or has its price. And since money can be divided and subdivided without a change in its value, it does away with the second inconvenience of barter, that of the indivisibility of all commodities.

Should possess the Quality of Universal Acceptability

In order to perform these two functions money should be a commodity of universal acceptability. For, if it were not so, the limit of its acceptability will also limit its usefulness. In order that all kinds of goods may be exchanged for money, it should be acceptable by all men. Its function of a common measure of value will also depend upon its universal acceptability, because its value depends on common consent to give goods in exchange for it.

Store of Value

(3) Money is a store of value, *i.e.*, it embodies value, for either conveying it from one place to another, or for keeping it from one time to another. Money can be sent from place to place more easily than commodities, and it can as well be stored more easily for future use.

Standard of Deferred Payment

(4) Money is a standard of deferred payment or register of debt. Borrowing and lending of goods becomes easy on account of this function of money. A man who sells goods to-day on credit, in fact, lends so many goods to get back at a future date. But instead of receiving goods at a future date, he gets their price in money. This is more convenient.

Should be Stable in Value

To fulfil the above two functions properly, money should possess the one very necessary quality of stability of value, *i.e.*, its value should not be changing from time to time but should be stable. If the value of money were changing, a lender could never be sure how much worth of money he will be getting back at a future date.

These are the four functions that money performs, and these functions of it tell us what money is. Money is, therefore, if we were to define it, "Anything which is widely accepted in payment for goods, or in discharge of other kinds of business obligations".[1]

Evolution of Money Material

It will be interesting at this stage to consider the process of evolution by which men have come to choose the precious metals to form the material for money. It should be remembered, however, that precious metals were not always used as money articles. At different times and in different communities, different commodities have been used to serve as money. And as Jevons says, "It is always useful, therefore, to be reminded of the truth so well stated by Turgot, that every kind of merchandise has the two properties of measuring value and tranferring value. It is entirely a question of degree what commodities will, in any given state of society, form the most convenient currency, and this truth will be best impressed upon us by a brief consideration of the very numerous things which have at one time or other been employed as money".[2]

Skins of Animals and Furs—Corns and Grains—Metals—Gold and Silver

When man was in the hunting stage, *i.e.*, when subsistence was gained by hunting wild animals, proceeds of the chase were considered to be most valuable and were most widely acceptable. Thus we find that skins of animals and furs were employed as money in many ancient nations. In the pastoral state sheep and cattle were considered to be most valuable and were employed as money. These had the further advantage of being easily transferable, and of being kept for many years. In agricultural state various kinds of corns and other agricultural products were used as money, such as rice in parts of India, oil in the Ionian Islands, tobacco in Virginia. Besides these, many other things have been used as money at different times by different people. The aboriginal Mexicans used cocoa, the Abyssinians used rock-salt, beaver and seal-skins were used in Arctic regions, cowries circulated in the East Indies, cocoanuts in Central America and so on. All the articles above mentioned possessed intrinsic value and, in addition, one or more quality to make them more suitable to work as money. For this very reason metals, being the most precious things available then, were first employed as means of exchange ; and besides being precious they possessed other qualities also, so that they came to be used as money universally. In metals also those, which became more common, were rejected and the choice has gradually risen to metals of higher value known as precious metals, *viz.*, gold and silver. But gold and siver are not the most precious metals ; there are some other metals which are more precious than gold and silver. The reason why gold and silver are selected as money metals are that they are comparatively precious and that they possess more qualities than other metals do, which make them the best fitted to perform the functions of money. The properties which an article should possess in order to serve as money material are enumerated below in the order of their importance :—

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[1] *Money*, Robertson, p. 3.

[2] *Ibid.*, Jevons, p. 19.

Qualities of a Material for Money

(1) Utility and value.
(2) Portability.
(3) Indestructibility.
(4) Homogeneity.
(5) Divisibility.
(6) Stability of value.
(7) Cognizability.
(8) Malleability.

(1) UTILITY AND VALUE.—In order to perform the functions of the medium of exchange and store of value, an article must possess both value and utility, because it is these that give it universal acceptability. It is true that

some articles as paper, which possess no intrinsic value, do circulate as money ; but it should be remembered, that in their case also, as we will see later, gold or silver is the basis of their value. In cases as in inconvertible paper, where the basis is not metallic, the currency of the paper is limited to the region where it is legal tender, or where people by common consent have decided to accept it as such. This shows, however, that intrinsic value, though not an absolutely necessary quality, is still of very great importance in determining the range of usefulness of money. An article possessing intrinsic value must be accepted by all people while another with no intrinsic value may be accepted or may not be accepted. Gold will be accepted in exchange for goods even at a place where it may not be circulating as money (as in India at the present day), but paper or any other thing not possessing utility will not be accepted unless it is a legal tender. Gold and silver possess both value and utility. They are and can be used for other purposes than for money ; and on account of their scarcity, their value is high.

(2) PORTABILITY.—The money article should not only be valuable, it should as well be portable, *i.e.*, it should be such as can be transferred from place to place easily and at low cost, and as can easily be carried by the owner in his pockets. Such an article can be one which possesses large value in proportion to its bulk. An article which is very bulky if transferred from place to place, will not have the same value everywhere. Gold, which possesses large value in proportion to its bulk, has roughly the same value all over the world, because the cost of carriage in its case is comparatively small. Though silver also possesses comparatively large value in proportion to its bulk, yet compares very unfavourably with gold in this respect. It will be very inconvenient, almost intolerable, to carry about any large sum in silver.

(3) INDESTRCUTIBILITY.—The quality of indestructibility is necessary in the case of an article which is to pass about in trade and kept in reserve. A perishable article cannot be kept in reserve or used for deferred payments. An article which either perishes altogether or decays or deteriorates cannot have the same value for all time. A money article should not have a changing value. Gold and silver are not destructible or perishable, they are not subject to wear and tear and are comparatively permanent.

(4) HOMOGENEITY.—A medium of exchange has a wide circulation. An article which forms it should be of uniform

quality, otherwise every part of it will have to be tested for its quality and thereby its value will be determined; this will mean a lot of inconvenience and waste of time. All pure gold is of the same quality. The value of one piece of pure gold is always the same as of another piece of the same size or weight. This quality of homogeneity makes the circulation of gold money very easy and rapid and its acceptability wide.

(5) DIVISIBILITY.—Divisibility does not only mean that an article can be mechanically splitted up into smaller parts, it as well means that it can be so divided without impairing its value. There are many things which can be divided, even an ox and a horse can be divided, but such a division will reduce the value of the parts more than proportionately. Gold and silver can be divided without impairing their value. If an ounce of gold or silver is divided into two equal parts, each part will be exactly half in value to the original piece.

(6) STABILITY OF VALUE.—The value of an article which serves as a standard of value should be stable. For a changing standard will always be very inconvenient and inefficient. A changing money standard will be as inconvenient and unreliable as any other changing standard, as a yard or a foot or a pound. Moreover, money is also used as a standard of value for long contracts; in such a case, any change in the standard will injure some section of the society. Gold has the merit of having a comparatively stable value. Not that the value of gold does not at all fluctuate, but it does so only slightly.

The reasons why the value of gold is comparatively stable are (some which have already been discussed) its indestructibility and portability and the fact that its cost of production is high. On account of the indestructibility of gold the stock of gold is comparatively very large in proportion to its annual production, and, therefore, any amount which is added annually to the existing stock does not affect its supply to the extent of affecting its value. The amount of gold available every year is, again, limited by its scarcity, and the cost involved in producing it is fairly high, which places a check upon an increase in its supply.

(7) COGNIZABILITY.—It means that a substance can easily be recognised and distinguished from all other substances. A medium of exchange must heve some distinct marks to identify it and which cannot be mistaken. This quality avoids the inconvenience of scrutinising, testing

and weighing the money every time that one got it. Gold and silver possess this quality of cognizability, and they can easily be distinguished from other things.

(8) MALLEABILITY.—In this quality may also be included those of fusibility and ductility. A money article should possess these qualities; it should be such as can easily be melted, beaten, rolled or drawn into thin or thick sheets, and which will receive impression easily. This quality makes the handling of the metal easier, and it can be made into a good coin, which being impressed with elaborate designs, cannot easily be counterfeited. Both gold and silver possess these qualities.

CHAPTER XXVI

COINAGE

Evolution of the Form of Metallic Money

HAVING seen how and why the choice of the present world rested on gold and silver as materials for money, it will as well be interesting to trace the gradual development of the modern form of coined money, since as we see, the form of metallic money throughout the world is almost the same at the present day. Most of these coins, leaving the coins of inferior metals, are round and flat, with designs on both sides, with milled edges and a rim put around them.

Ingots and Bars

At first the metals were used in the form of ingots or in that of bars which had to be weighed in order to ascertain their value. Gold, which is most readily obtained in the form of dust or grains from alluvial deposits, was first used as money in this form. It was later on that the gold grains or dust were melted and shaped into ingots or bars. Since the process of weighing the ingots or bars everytime to ascertain their value was very cumbersome, some of the merchants began to make their ingots of a fixed standard of fineness and weight and placed their private marks upon them. Those who knew these merchants and had confidence in them accepted the ingots at their face value. But in this case also the ingots could be accepted by a few and were generally weighed. Later on other improvements were made in the form of the coins with a view to making them more convenient in handling and less liable to be clipped and counterfeited.

Ring Money

In the words of Jevons, "the ancient Goths and Celts were accustomed to fashion gold into thick wires, which they rolled up into spiral rings and probably wore upon their fingers until the metal was wanted for trading purposes. There can be little doubt that this ring money, of which abundant specimens have been found in various parts of Europe and Asia, formed the first approximation to a coinage." A flat circular coin, which was later on evolved, proved more convenient in handling and was the least open to fraudulent alteration and wear and tear, and could be carried about in pockets without injuring the cloth.

Designs on Both Sides and Milling of Edges

In order to further check fraudulent clipping and counterfeiting, these flat, circular pieces were covered with designs on both sides. Later on the edges of the coins were milled to check any clipping from the edges. And ultimately coinage was taken up by the Government or the Sovereign power, who fixed the standard of fineness of the metal contained in the coin and, at the same time, fixed its value and made it a legal tender.

Thus, we see, how the modern form of coin evolved. The idea has been to evolve a good coin which may be accurate in composition and weight, convenient of shape, size and weight, which may not easily be counterfeited and which may be durable and cognizable. With this end in view, coins are at the present day made in Government mints equipped with elaborate machinery to produce as perfect coins as possible in composition and form. All coins of one kind contain an equal proportion of metal and alloy and all are of the same size and weight. This uniformity of composition and weight and form has been attained to a very great extent, still slight variations sometimes occur.

Tolerance of the Mint

Such a variation is known as *tolerance of the mint.*

Rim

Coins are not made of pure gold or pure silver, but an alloy of baser metal is mixed in order to make them hard and tough enough to reduce loss by abrasion or wear and tear to a minimum. The durability of the coin is further promoted by putting a *rim* around it, so that the coin may rest on this rim.

Milled Edges

In order to check counterfeiting and clipping, the coin is covered with designs over the entire surface of both sides and its edges are *milled.*

Coin

Since coins are now minted by Government who put on the coins their own designs and certify the fineness of the metal and the weight, they (coins) are recognized by the people as such and are accepted at their face value. A coin has been defined by Prof. Jevons, as "an ingot, of which the weight and fineness are guaranteed by the Government and certified by the integrity of designs impressed upon the surface of the metal". The Government thus have a monopoly of coinage, and the manufacture of coins by anybody else is a crime. But all Governments do not coin money on the same principle. Some coin it only on their own account, while others coin it both on their own and on that of individuals. Some Governments make a charge for coining money while others do the coinage free of charge.

Limited Coinage—Free Coinage—Gratuitous Coinage—Brassage—Seigniorage

When the coinage is only on Government account it is called *limited coinage,* while it is called *free coinage* if it is done on account of individuals. Free coinage does not mean that no charge is made for coinage. In case no charge is made, it is called *gratuitous coinage* ; but if a charge is made and it is equal to the actual cost incurred in coining, such a charge or fee is called *brassage.* If the fee charged is more than the cost then it is called *seigniorage.* In practice, however, the term seigniorage is used for brassage also, and also indicates the Government profit on coinage whether the work is done for individuals or not. India has a limited coinage. Here coins are not manufactured on individual's account. In England coinage was, till some time back, both free and gratuitous and she was the only country which had both free and gratuitous coinage. Most other countries such as U.S.A., France, Germany, etc., make a charge for coinage.

Mint Price of Gold

The rate, at which a certain number of coins are made from a certain quantity of gold bullion, is called the *Mint price of gold.* In England the mint price of gold was £3-17-10½ per ounce, *i.e.*, each ounce of gold was manufactured into sovereigns at this rate. The mint price of gold is 3,447·74 francs per kilogram in France and 2,790 marks per kilogram in Germany.

Full-weight Coins—Tokens—Standard Coin—Subsidiary Coins

India has nothing like mint price of gold or mint price of silver, because on the one hand, her coinage is limited and on the other, the coins minted in India are not full-weight coins ; they are token coins. A *full-weight coin* is one, the money value of which is equal to its bullion value, while a *token coin* has a higher money value, which is given to it artificially by the Government. Thus we see that a sovereign is a full-weight coin, while the rupee and the shilling are tokens. But a token coin can be a standard coin as much as a full-weight coin can be. A pound is a standard coin and so is a rupee. A *standard coin* is one to the value of which the value of other coins, tokens and subsidiary, and of other kinds of money, is referred for determination. *Subsidiary coins* are coins of smaller denomination which are multiples of the standard units. They are always tokens.

Legal Tender

We have seen that in the beginning it was on account of mutual agreement and understanding amongst the people that they adopted money as the universal means of exchange. Then the Government steps in ; it makes the coins, guarantees their weight and standard and compels the public to accept them in payments of debts ; in other words, it makes the coins legal tender. "*Legal tender money* is money, the offer or tender of which in payment of debt constitutes, under the law, a sufficient discharge of the obligations."[1] The legal tender quality of money makes it more readily acceptable and gives it a wider circulation for people who accept it are sure of the fact that they can tender it to anyone in discharge of a debt whenever they may so desire. But all money is not legal tender to the same extent. Usually the standard money is legal tender to an unlimited extent, while subsidiary money is legal tender to a limited extent. The former kind of money is called *unlimited legal tender* and the later *limited legal tender*.

Systems of Metallic Currency

There are various systems of metallic currency. What particular system will be in use at a particular time will depend on the development of coinage and on the scale of incomes and prices. When metal is either uncoined or coins are rudely made, they pass by weight. But coins, when they are well made and are accurate, they pass by tale. Again, coins only of a single metal will suit a community with uniform scale of incomes and prices, while a community with different incomes would need coins of different metals. Prof. Jevons has, accordingly, divided the possible systems of currency into five classes.[2] Currency by weight, unrestricted currency by tale, the single legal tender system, the multiple legal tender system and the composite legal tender system.

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[1] *Money*, Kinley, p. 47.

[2] *Ibid.*, Jevons, Ch. IX.

Currency by Weight—Currency by Tale

Under *currency by weight*, the Government provides a system of weights and measures for people to weigh out or measure out the metal used as money. Under the system of *unrestricted currency by tale*, the Government issues pieces of metals certified to be equal to units of weight. The pieces circulate amongst people on the basis of this certification. In international payments, gold bars made at the Government mints are used; and this is the nearest approach to this system at the present day.

Single Legal Tender System—Multiple Legal Tender System—Composite Legal Tender System

Under the *single legal tender system* only one metal is coined by the Government, and the coins of it alone are legal tender. *Multiple legal tender system* is one under which coins of different metals are used at a fixed ratio, and each is legal tender to an unlimited extent. Bimetallism is the most familiar example of this system. *Composite legal tender system* consists of one coin as unlimited legal tender, while other coins are legal tender to a limited extent only. Almost all the advanced countries to-day possess this system.

Paper Money

So far we have talked only of metallic money. But besides metals there are other materials also which are used for the manufacture of money. The most common material used for this purpose is paper. People found out that paper money is more convenient in its use, is cheaper and can be carried about more easily; this fact has made paper money very popular and important.

Paper money is issued by either the Government or by banks, where banks are allowed to do so. It is unlimited legal tender. Generally both metallic money and paper money are legal tender at the same time.

Chapter XXVII

PRINCIPLES OF CIRCULATION

Currency and Non-Currency

The medium of exchange, or the circulating medium, consists of various kinds of instruments used for paying debts or purchasing commodities. These various instuments are of varying currency. Some of them have a general circulation, while others do not have a general circulation. The media of exchange can thus be classified into (*a*) the medium of general circulation or the currency and (*b*) the medium of restricted circulation or non-currency.[1]

The first, the currency, consists of metallic money of all kinds and paper money of all kinds. The second consists of credit paper like cheques, bills of exchange, promissory notes, etc., which does not circulate generally.

Medium of Exchange Complex

Thus the medium of exchange at the present time is not simple and homogeneous but is complex and heterogeneous. The medium of exchange is generally composite, and it is not an accident that it is so. It is due principally to two reasons, firstly, on account of the need of adapting the currency to a variety of grades of incomes and payments and secondly, the necessity of having coins convenient to handle. People have tried to adopt the best form of medium of exchange, and they found that a complex currency is more convenient than a simple one.

Cause of Circulation of Money

The chief and the fundamental cause of the circulation of any and all kinds of the media of exchange is confidence in their acceptability. It is on account of the persistence of social habit that commodity money circulates widely. Gold is more widely acceptable than any other kind of money; the reason is the universal confidence in its value. But this value of gold depends upon its demand. It has value only till people want it. That people have confidence in the value of gold means that they believe gold will be demanded as usual, and its acceptability is universal.

Money issued by a Government and made legal tender, is acceptable because on the one hand, people have confidence in the Government and on the other, they are sure that on account of the authority of the Government the money issued is acceptable by all its subjects.

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[1] *Money*, Kinley, p. 40.

Money issued by a Government or an individual or a corporation is acceptable because of the confidence in the integrity and stability of the issuer. Here the receiver is sure that the issuer will redeem the money, if any one else does not.

Lastly, the confidence which people have in the acceptability of an article may be the result of an agreement amongst a group of people to accept it as money.

Area of Circulation

Whatever be the cause or basis of the confidence, the chief reason why money circulates is this confidence in its acceptability. It circulates because the receiver believes that others will take it from him in return. The area of circulation depends on the basis of the confidence. The area will be limited to only a small group, where the basis of confidence is the integrity or credit of the issuer. It will be wider if the confidence is influenced by political or legal authority and it will be the widest where confidence is the result of universal acceptability of the article on account of social habit.

It is not necessary, however, that the different portions of an article, which is generally acceptable as money, may have the same degree of acceptability. For example, all the coins of a metal and of equal denominations, after some time, are not of equal weight and fineness ; some may have been subject to greater wear and tear. Those which are less worn out or are better coins, may do more work than the worn out ones. They may not only be used for ordinary payments, as do the inferior coins, but also for foreign payments and for employment for other purposes.

Gresham's Law

On this experience an important law of currency, known as the *Gresham's Law* is based. The law is named after Sir Thomas Gresham, an Elizabethan Knight and founder of the Royal Exchange, who first formulated the law in a scientific form. The law, in its earliest and simplest form, is expressed as follows :—"If coins of the same metal, but of varying weight and quality, circulate together at the same nominal value, the worse coins will tend to drive the better from circulation, but the better will never drive out the worse." [2]

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[2] Quoted by Sykes in his *Banking and Currency*, p. 16.

Coins of the Same Metal

The action of the law is quite natural. When a man has to part with a coin he will naturally part with the least valuable provided it exchanges for as much as the more valuable coin does. Again, those who hoard money will try to hoard the best coins and those who export will pick out the heavy coins for this purpose, as in international transactions, currency always goes by weight and not by tale. Thus on account of the operation of Gresham's Law, heavy coins disappear from circulation ; some of them are exported or melted down, others are hoarded, and some are fraudulently depreciated in weight. "The bad money drives out the good."

Under Bimetallism

So far about coins of the same metal ; but Gresham's Law applies to the coins of different metals also. Under bimetallism or a currency in which two precious metals are used, both circulating at a mutual valuation fixed by the State ; the values so fixed may not always be in the ratio of their intrinsic values. The ratio of the market value will differ from the mint ratio or the ratio of the values fixed by the State, if there is any difference in the value of one of the metals brought about by changes in its supply or demand. The metal which becomes cheaper is said to be overvalued for currency purposes, while the other which becomes dearer is undervalued. In such a case the overvalued metal will drive out the undervalued one from circulation. This may be formulated as follows : "If coins of two precious metals be circulated at a fixed ratio of exchange with one another, the overvalued metal will tend to drive the undervalued from circulation." [3]

Paper Currency

There is a third form of this law applying to the relations between a metallic coinage and a paper currency. The law applies only to the relations between coins and that kind of paper money which is not convertible. For convertible paper money is as good as gold and people will not make any difference between the two. But where inconvertible paper money is issued, and people lose confidence in this inconvertible paper on account of an over issue of it, the paper money begins to depreciate in value. Gold begins to be withdrawn from circulation and is exported or hoarded. Gresham's Law begins to apply and its third form may be noted as follws: "If an inconvertible paper currency be issued in excess, that is to say, to such an extent that the total amount of the currency becomes greater than the normal amount required by the country, it will tend to drive the precious metals from circulation."

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[3] *Banking and Currency*, Sykes, p. 19.

CHAPTER XXVIII

PAPER MONEY

Use of Paper, a Logical Evolution

THE use of paper money is logical evolution in the progress of the monetary system. The puzzle, that a scrap of paper can serve the purpose of money just as well as a piece of precious metal does, disappears when it is realised that men want money for paying their debts and to exchange for commodities. "A coin is simply an order on every producer to hand to the bearer a certain quantity of goods, and that order can be conveyed quite as well by a written paper, if there is the same sanction or authority behind the written paper, namely common consent, upon which in the long run even the gold or silver coin depends for its value."[1] If people are willing to accept a thing in payment of debts and in exchange for goods, that thing, be it gold or silver or copper or paper or anything else, will work as money quite all right.

Paper More Convenient

It is the idea of convenience which led people to replace one article with another for manufacturing money. The more convenient and suitable article has been adopted and the less so has been rejected. Exactly this is the reason for the use of paper as a money article ; it is more convenient than metal. Paper money can easily be carried about ; it occupies less space ; it is easier and less expensive to transfer it from place to place ; there is no question of wear and tear in its case, as new paper at almost insignificant cost can be issued in place of the old one ; and its use relieves a large quantity of precious metals to be used otherwise.

Circulation Depends upon Common Consent ; But not a Universal Money

Just as in the case of metallic money so in the case of paper its circulation and use as money depend on common consent. If people agree to accept paper money, there is no reason why it should not circulate freely. And people accept paper money because they find that it not only serves the purpose of money just as gold or silver does but it is also a more productive form of money, since it replaces the use of gold and silver which are set free for other uses. The entire displacement of the metals by paper would be possible, however, if paper money were exactly alike metallic money. But this is not so. There are certain differences between paper money and metallic money and it is on account of these differences that paper money, in fact, is not a universal money like gold.

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[1] *The Mechanism of Exchange*, Todd, p. 78.

Value More Precarious

In the first place, the value of paper money is more precarious than that of metallic money. The value to the paper is given by the issuing authority and that value can also be taken away by a stroke of the pen if the issuing authority so desires. Gold coins, even if they cease to be legal tender, retain their bullion value.

Restricted Currency

Secondly, the value of paper money is restricted to the territory of the Government which issues it. Beyond that territory it would not be accepted as there it is not legal tender. The value of gold coin on the other hand depends on its bullion value, which is the same all the world over ; and it is gold thus which is truly the international and universal money.

Unstable Value

Finally the value of paper money is more unstable than that of metallic money. The value of money depends on its quantity. It is very easy in the case of paper money to increase its quantity, for it only depends on the will of the issuing authority to print a few more of paper notes, at no cost. Such cannot, however, be the case with gold. To increase gold coins is expensive and confers no gain on the currency authority.

Representative Paper Money

Paper money is of three kinds ; Representative paper money, Fiduciary or convertible paper money, and Inconvertible or convertional paper money. Representative paper money is merely certificates of deposit or receipts for a certain amount of gold or silver deposited with the issuer who promises to return the amount deposited, to the owner on presentation of the receipt. Such money may be issued by banks or by governments. The silver dollar certificates of the United States are an example of this kind of money. Representative paper money has the only advantage of its being more convenient to handle in bulk than the coins, but it does not in any way economise the use of metal.

Fiduciary or Convertible Paper Money

By convertible or fiduciary paper money is meant the notes issued by a bank or a government, promising to pay the amount expressed on the paper in coin. The coin has to be paid immediately on presentation of the notes. Fiduciary money may be issued either against a specific deposit of metal kept in order to redeem the money or against the general credit of the issuing authority. Generally some deposit of money is always kept, which is less than the amount of notes issued to the extent of notes which it is considered will in no case be presented for redemption.

Government Issue and Bank Issue

Though such paper money is issued both by governments and banks, bank money is better. It is in fact not the function of the government to issue and redeem paper money, which partakes of the nature of banking. Government paper money does not possess the quality of elasticity which bank money does. The amount of paper money issued by government is usually limited by law, in order to avoid the danger of being confronted with the demand for redemption beyond its power. Government paper, again, is issued without any regard for the needs of business. Thus its limitation, together with the mode of issue deprives government paper money of the power of automatically increasing and decreasing in volume with the need of business men for currency.

Elasticity of Currency

Elasticity of currency which means the automatic expansion and contraction of the currency according to the needs of business, is the first essential quality of a good currency. The business need for currency is not the same at all time. At some time business is slack at another it is brisk. When business is brisk, there is need for more money than it is when business is slack. If the quantity of money were not varying with the varying needs for it, the prices of commodities will be widely fluctuating and will thus introduce the element of speculation and uncertainty in business and may even go to dislocate business. In some countries there are seasonal demands for more currency. In argicultural countries more money is needed to finance agriculture at times of harvests. At such times more money should be coming forward to meet seasonal demands.

Bank Money Elastic

Bank money has this very desirable quality of automatically expanding and contracting with the requirements of business. Bank notes, or convertible paper, are issued by banks to those who deposit metal with the bank, who take a loan from the bank or who get their bills or promissory notes discounted with the bank. Most commonly bank notes are issued against discounted bills. When business is brisk there are more commercial bills which are discounted and the banks issue more notes and thus expand the currency. But when business becomes slack and there is less need for currency, on the one hand less bills come for being discounted and on the other business men finding more money with themselves than they require, return a part of that money to the banks in meeting their bills ; and thus currency is contracted. We see, therefore, how the mode of issue of the bank notes goes to automatically expand and contract the currency according to business requirements.

Banking and Currency Theories

There are two opinions regarding the issue of bank notes. The one is that the issue of bank notes should be regulated by law and the other is that no such regulation is necessary, but is rather undesirable. The first theory that which favours regulation is known as the *Currency Theory*, and the other is known as the *Banking Theory*. The banking theory holds that if notes are always convertible, and if they are issued against genuine commercial paper, no precaution is necessary to prevent their excessive issue. The fact that notes are always convertible is sufficient to infuse confidence among men and there is no reason why more than very few of notes should ever be brought for conversion. Besides this when they are issued against genuine commercial transactions, they cannot be issued in excess of business needs.

In theory the banking principle is without a flaw. But experience has shown that banking is not always sound and careful ; that credit is, at times, allowed by banks to finance doubtful business ventures, and that by lowering the rate of discount and making credit cheap, greater amount of it, than is actually necessary for business purposes, is made available by them. For this reason some control or regulation of bank note issue is necessary in the interest of safety. But this does not, however, justify the requirement of the current theory, that the amount of convertible paper should be fixed by law. It justifies only measures which will safeguard against expansion to meet illegitimate needs, and which will leave issues free for all legitimate business requirements.

Methods of Regulating Issue

There are many methods of regulating convertible note issues. The principal ones are those which directly act on the reserve. Those which act on the notes, *i.e.*, limit their volume have already been rejected as they devoid the currency of the property of expanding beyond the limit prescribed.

So far as the other method of controlling reserve is concerned, it consists of regulations for the maintenance of a specific reserve against the notes issued. The law may require a reserve of specie either equal to the whole amount of issue or a part of it or a certain proportion of it. In some cases the bank is allowed to issue notes to a certain limit for which it is not required to keep cash, but beyond this limit every note issued has to be backed by an equal amount of cash kept in the reserve. Such is the case with the Bank of England. The system is not elastic, and it has been possible in England because of the very popular use of the cheque.

The system of note issue of the Reichsbank of Germany is an improvement. The Reichsbank, like the Bank of England, is allowed to issue notes upto a certain limit without covering them with cash, and for every issue beyond this limit specie has to be kept as a backing. But unlike the Bank of England the Reichsbank has the elastic limit of its note issue. The fiduciary portion is not absolutely limited but can be increased in times of emergency. The bank can issue notes beyond the prescribed limit, but is required to pay a tax at the rate of 5 per cent. a year on the excess. This provision enables the bank to provide extra currency when it is needed ; and since the bank has to pay a tax it safeguards against any over issue.

Inconvertible Paper Money

Inconvertible or irredeemable paper money consists of notes for which specie is not obtainable on demand. It may either be issued by a Government or by a bank ; but it is generally issued by a government, which has no coin, and is in need of money to pay its debts or supply its requirements. It is possible for such pieces of paper, which possess no intrinsic value of their own, to circulate and do the work of money if they are invested by law and common consent. "Inconvertible paper money issued by a government passes from hand to hand, if it passes at all, either because the people have no better money, and the quantity of it is so limited that its evils do not yet appear, or because the government is strong enough to compel its citizens to accept the paper. Since it answers their purpose, the people are content to use it."

Advantages

The advantages of the inconvertible paper money are those of convertible paper money and a few more. Its use saves the loss on account of wear and tear of coins, it is easier and less expensive to transfer it from place to place, it is more convenient to handle it, and above all it is the most inexpensive form of currency, which on the one hand saves society of the cost of producing precious metals for use as money and on the other, relieves a large amount of precious metals to be used for other purposes.

Dangers

But if inconvertible paper has its advantages it has its dangers too; and experience has shown that its dangers have always out-balanced its advantages. As has been said earlier inconvertible paper is less stable in value, has a restricted circulation and has a variable demand. On account of the smaller area in which it is accepted, its demand is variable and its value uncertain and changeable. Its supply is dependent on the caprice or the policy of the issuing authorities, and this is the greatest danger of paper money. It costs nothing to issue more of inconvertible paper; and the temptation to issue more is so great that few governments issuing inconvertible paper have been able to resist it.

Over Issue

The evils of paper money lie in its abuse; so long as the amount issued is not in excess of the currency requirements of a country, there is nothing to fear, but anything beyond this is absolutely fatal. In other words harm would arise when paper money is issued in quantity larger than the specie it displaces. Paper money unlike gold and silver cannot be exported or melted. So that any amount which is issued beyond the needs for currency must remain in circulation. "After the paper has driven out the coin, further issues go to swell the volume of home currency and accumulate like water in a pond that has no oulet."[2]

The idea that paper money, even issued in excess by a government in whose credit people have confidence, will not cause any harm, is erroneous. Experience has amply shown that, "the only thing that matters to the value of a paper currency is the amount issued. If that is not too much it will pass current perfectly well, though the credit of the government be hopelessly bad ; while, on the other hand, if the issue is in excess of the real requirements of the country, it will depreciate absolutely beyond all prevention no matter how high the credit of the government stands."[3]

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[2] *Money*, Kinley, p. 337.

Depreciation in Value

When inconvertible paper is over-issued it depreciates in value. And since it is not convertible, people begin to lose confidence and are alarmed, and this leads to its further depreciation in value. So that in reality it depreciates to a greater extent than the actual excessive issue would warrant. A depreciation in the value of money means a rise in prices ; and the necessity for more money is felt. This leads to a further issue and a further deprecation and a further loss of confidence, and may ultimately make the paper worthless. This is actually what happened in the case of the German marks during the Great War and with the French assignats during the Revolution.

Signs of Over-Issue—Premium on Gold

The only remedy to save the country of the disastrous effects of an over-issue of paper is to stop all further issues and to withdraw from circulation the amount which may be in excess of the needs of the people. There are certain signs which make it possible to tell when the limit of safe issue has been overstepped. The first sign indicating an over-issue of paper money is the emergence of a premium on gold. This premium first manifests itself in a rise in the rate of foreign exchange. In the internal market gold bullion begins to be sold at a higher price in terms of depreciated paper.

Disappearance of Gold

The next sign of depreciation is the disappearance of gold. Gold is either hoarded or sent abroad in payment of foreign debts and only inconvertible paper remains at home.

Rise in Prices

Next to these a depreciation in the value of paper brings about a rise in prices. On account of a premium on gold importers have to pay more for their imports. They, therefore, in order to recoup themselves of this loss, raise the prices of their goods. The raising of prices by importers is infectious, and as a result, prices are also raised by others.

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[3] *Mechanism of Exchange*, Todd, p. 86.

Duplication of Prices

The last and the fatal sign of an over-issue is the duplication of prices, *i.e.*, two prices are charged for an article, a higher price when payment is made in paper money, and a lower price if it is made in gold.

Evils of Depreciating Paper

The evils of depreciating paper money cannot be overemphasised. A rise and fluctuation in prices introduce an element of uncertainty in business ; and business becomes of a speculative character. With the introduction of speculation a desire to get rich quickly is stimulated, and people leave habits of steadiness and sound business methods. With a sudden and great rise in prices business men begin to consider themselves suddenly growing rich, and begin to lead an expensive life. But when the over-issue is removed or paper money is contracted, prices fall and business men find themselves poorer ; there is a general depression and for a time enterprise is deadened. Again, on account of a rise of prices, wage earners and salaried classes are very adversely affected, as their real income is thereby reduced.

Remedy

As has already been said above the only remedy for over-issue is to stop further issues and to withdraw the excessive portion from circulation ; or, in other words, to make the inconvertible paper convertible, till all the redundant portion of it has been returned to the government. The remedy is simple and yet is most difficult. The government which over-issues paper money is hardly in a position to redeem it. The government issued the paper only because it had no gold. But whatever be the case, and in whichever way it may be possible, the over-issued portion must be withdrawn ; and that is the only remedy to save a country of the disasters of such an over-issue.

CHAPTER XXIX

THE VALUE OF MONEY

THE value of money is its 'purchasing power'. In most cases money is not wanted for its own sake, but for the sake of commodities and services that money can purchase. If money at any time purchases more commodites and services than before its value is to that extent higher and if at another time it purchases less of these, its value is lower. A change in the value of money is thus reflected in a change in the value of commodities and services in general, because money exchanges with or purchases practically all the commodities and services. Thus when money purchases more of these its purchasing power is greater or its value is higher and at the same time to that extent the value or price of these commodities and services is lower, *i.e.*, prices in general fall. On the contrary when money purchases less of commodities and services its value has fallen and the price of commodities and services has risen. But the price of all commodities and services may not rise or fall to the same extent with a certain fall or rise in the value of money. To have an idea as to how much in general prices have risen or fallen an average of the prices of various commodities and services is taken and such an average is called the *price-level*; and a series of price-levels is called the *Index-numbers.*

Index-numbers

Index-numbers are thus tabulated figures of price-level, which indicates the changes in prices of goods and services. They are statistical average of the prices of different commodities and services showing the fluctuations in the value of money. A rise in the price-level indicates a fall in the value of money and a fall in the price-level indicates a rise in the value of money. The value of money varies inversely with the price level.

Construction of Index-numbers

In constructing Index-numbers a base period is taken and prices of other periods are compared with those of the base period. A number of commodities are selected; their prices at the base period and at other periods are found out, the average of these prices are calculated and these averages then are compared to find out the change in prices. The following example will make the meaning clear. In this example the base year is 1939 and the other year is 1942. The purpose is to find out how much prices of certain commodities have risen or fallen in 1942 as compared with those in 1939. For the sake of simplification we may take only a few commodities :

		In 1939 (base year)	In 1942
Wheat	per maund	Rs. 4=100	Rs. 5= 125
Rice	per maund	Rs. 8=100	Rs. 10= 125
Sugar	per maund	Rs. 10=100	Rs. 12= 120
Pulses	per maund	Rs. 6=100	Rs. 6-8= 108
		400	478
Average=		400÷4 =100	478÷4 = 119½

This simple illustration shows that the price of the four articles was represented by 100 in 1939, the price-level of these in 1942 has risen to 119½, *i.e.*, by 19½%.

Base Period

It is the year, month, week, day or any period which is taken as the standard or the starting point and with which prices of other periods are compared. Care should be taken in selecting the base period that so far as possible it should be a normal period.

Selection of Commodities

The selection of commodities should depend on the purpose for which the Index-number is constructed. If the purpose for instance is to find out changes in the cost of living of the working classes, the commodities selected should be those which are generally used by the working classes. If the purpose is to measure the value of money, the goods and services of all types should be selected. Again the commodities selected should be uniform in quality over different periods for if their quality changes in different periods the index-number will give a false indication of trend of prices.

To get the best results a large number of commodities should be selected. In fact the larger the number of commodities selected the more accurate the results would be.

Weighting

All commodities are not of equal importance nor are commodities used in the same quantities by all people. This may therefore necessitate giving due weights to different commodities in accordance with their comparative importance. Weighted index-numbers are more accurate than the unweighted ones.

Appreciation and Depreciation of Money

Appreciation means a use in the value of money, *i.e.,* a fall in the general level of prices and depreciation means a fall in the value of money and a rise in the general level of prices. Appreciation in the value of money may be the result of Inflation and depreciation in its value may be caused by Deflation.

Inflation and Deflation

Inflation means putting into circulation more money than is required, *i.e.*, if the supply of money is at any time greater than its demand it is said to be a state of Inflation; and on the contrary if the supply of money is less than its demand it is a state of Deflation. In actual practice Inflation means a deliberate increase in the supply of money as compared with its demand and Deflation means a deliberate contraction or reduction in the supply of money. Since it is not possible to accurately ascertain the demand for money at any time, the only indication about Inflation or Deflation is through the behaviour of price-level. If there is a general rise in the price-level it is usually due to Inflation and if there is a general fall in price-level it is usually due to Deflation. It is usually so not necessarily so. Rise and fall in the price-level can be due to other causes also. But other things being the same Inflation and Deflation will certainly affect the price-level. If currency is inflated prices will rise and if currency is deflated prices will fall.

Their Effects

The effects of Inflation and Deflation are felt through a changing or fluctuating price-level. Widely fluctuating or changing prices are inconvenient, and Inflation or Deflation always causes wide fluctuations in prices. Wide fluctuations in prices create a state of uncertainty for genuine economic activities. The producer, the business man is not sure if he will make a profit or will incur a loss. This state of uncertainty injures commerce and production while it encourages speculation.

Effects on Different Classes

Again a change in the value of money does not affect different individuals or classes equally or in the same way. When prices rise business men and producers gain, as higher prices mean higher profits and greater incentive to production; but the working classes lose as their real incomes are thereby reduced. If prices fall the two classes are affected contrarily. When prices rise debtors gain and creditors lose and when prices fall creditors gain and debtors lose. Since debts are paid and received in money, at rising prices the creditor receives lesser purchasing power and at falling prices receives greater purchasing power.

Rising prices act as stimulus to production, thereby production increases and provides greater employment. There is greater prosperity, State income increases and there is greater expenditure on public works and public utility services. When prices fall there is depression, production is reduced, employment is curtailed and public expenditure is reduced. But when prices rise the cost of living of working classes rises and in their efforts to raise wages they go on strike ; while when prices fall employers reduce wages, deploy labour, declare lock-outs and there is general social unrest and distress.

Thus we see that both rising and falling prices are harmful. During such periods if some classes gain others lose and they create a state of uncertainty and either undue optimism which may lead to waste, extravagance and gambling or undue pessimism which usually leads to idleness of productive resources. A stable price-level is the best, it leads to more harmony and better relations between different classes of people and greater stability of the social and economic structure. To have a stable price-level one necessary condition is to have a stable value of money.

The Value of Money

What determines the value of money ? Money is a commodity. The value of a commodity is determined by its supply and demand. But money differs from other commodities in a particular respect. Whereas other commodities are required for their own sake money is required for the sake of other commodities. Money is a medium of exchange, it is required for exchange with other commodities.

Quantity Theory of Money

"The value of money, under the simplest conditions, is exactly inverse to its quantity" (Taussig). If the quantity of money is doubted its value becomes half, if its quantity is halved its value is doubled. If the quantity of any commodity is increased its value will fall and if its quantity is decreased its value will rise ; this is true of money also. The peculiarity however is that the value of money increases or decreases exactly in the same proportion in which its supply or quantity decreases or increases. If the supply of wheat is doubled its value will surely fall but not necessarily to half its previous value. But this is what is said will happen with money. Other things remaining the same and under the simplest conditions the value of money is exactly inverse to its quantity. This is the quantity theory of money. The theory that the value of money is exactly inverse to its quantity only lays down the essential ground and the fundamental truth of the tendency about changes in the value of money. In any actual instance it is never absolutely correct. It is under the simplest conditions and other things remaining the same that the value of money will change exactly inversely to a change in its supply. Since actual conditions are never the simplest nor do other things remain the same, an actual instance of its absolute application may never be cited. But this does not however mean that the tendency as contained in the theory is not correct. Before we examine the other things and qualifications we will consider the essential ground on which the theory rests.

There is one essential difference between money and other commodities. All the money (except a small amount that may be hoarded) is spent sooner or later. It is spent on buying other commodities or in exchanging with them. The demand for money is thus constituted by all the commodities for sale. The demand for money at any time therefore will be *constant*. Whatever the quantity of money be the whole of it will be used in exchange with the exchangeable commodities. If there is more money, more of it will exchange with the number of commodities for sale ; if there is less of it, less will do the same work and exchange with all the commodities. In other words the elasticity of demand for money is *unity*. In the case of other commodities the demand for some is elastic, of others inelastic, but the demand for money at any time and in any community is constant, the same. In this respect is money peculiar. Therefore when the quantity of money increases, its demand remaining constant, more money does the same work which less was doing before and its importance or value therefore to that extent becomes less and *vice versa*. For example if we suppose that the number of exchangeable commodities is 100 and money units in circulation are 100, then 100 units of money will exchange with 100 units of commodities and on an average 1 unit of money will exchange with 1 unit of commodities and therefore the value of 1 unit of money will be 1 unit of commodities. If suppose the quantity of money increases from 100 units to 200 units and the number of commodities remains the same, then, now

200 units of money will exchange with 100 units of commodities or 2 units of money will exchange with 1 unit of commodities or 1 unit of money will exchange with ½ unit of commodities. The value of each unit of money has thus become half as its quantity doubled. Similarly if the quantity of money were to decrease from 100 units to 50 units and the quantity of commodities remained the same, 50 units of money will do the work of 100 and each unit will have double the value.

Qualifications

The above example illustrates the simplest conditions and all other things remaining the same. In actual life other things are hardly the same nor do the simplest conditions obtain. We have therefore to consider now the qualifications of this fundamental principle and other things which do not remain the same and which do not allow an unalloyed application of this theory.

Goods Consumed by the Producer and Barter

All the commodities that are produced at any time may not be available for exchange. Some may be consumed by the producers themselves. This is particularly so in agricultural production and also to some extent in small-scale handicraft production. It is true that the amount of such commodities which are directly consumed by the producers is very small in modern times, yet they have to be deducted from the total stock of commodities which constitute the demand for money. Again, all the commodities even available for exchange may not necessarily be exchanged with money. Some of them may exchange directly with other commodities. In other words, there may be barter prevalent to a certain extent and to that extent these commodities though they exchange they do not constitute demand for money. It is again true that in modern times barter transactions are very few and practically negligible.

Rapidity of Circulation of Money

But more important than the above qualifications is the rate at which money circulates or exchanges with goods. The supply of money does not merely depend on its actual quantity in existence. It depends also on the actual amount in use and the rate or speed at which it is being used. Money lying buried underground or in peoples strong boxes or in the vaults of Banks is not money in circulation. It is thus the flow of money not its fund which constitutes its supply. Again the units of money which are being used for exchange may be doing that work slowly or rapidly. Each unit of money may exchange with several units of goods in the same time or with only a few. The more rapidly units of money exchange with goods or the greater their rapidity of circulation greater is their supply or quantity. Both the quantity of money in circulation and its rapidity of circulation will depend on the habits of the people and their economic development. In a backward agricultural community less money will be in circulation and it will circulate slowly as compared with an advanced manufacturing and business community.

Rapidity of Circulation of Goods

If money has its rapidity of circulation so have goods. The rate of their turn-over constitutes their rapidity of circulation. Goods may be produced and exchanged slowly and leisurely or rapidly. In a large city the rapidity will be greater than in the country ; it will be greater amongst a restless and energetic people than amongst a slow moving people ; greater in a manufacturing and commercial community than in an agricultural and pasturing one. But the difference in the turn-over or rapidity of circulation of goods will make a difference in the demand for money just as a difference in their physical quantity would.

So that when we talk of the quantity or supply of money it does not mean the physical quantity of money but its flow and the rate at which it is flowing. And when we talk of its demand it is not merely the physical quantity of goods but their flow and the rate of their flow.

Credit and Credit Instruments

By money we mean the medium of exchange. It is not only metallic money and paper notes which form the medium of exchange but besides them credit instrments like Cheques, Bills of Exchange, Drafts, Promissory Notes, etc., all go to constitute the total media of exchange which does the work of exchange. Therefore the quantity of money at any time will include all types of media of exchange and in the affects of its quantity on its value it is the total quantity of the media of exchange and not merely the quantity of legal tender money which should be taken into account.

Chapter XXX

THE MONETARY SYSTEM

There can be different systems by which the currency of a country may be managed and controlled. The object of management of currency is to make, as far as possible, its internal and external value stable so that the internal and external price-levels may remain stable or at least may not fluctuate widely. In some cases the currency is linked to a particular metal, in some to more than one metal and in some it is not linked to any metal. Where the currency is linked to any metal, that metal is the standard of value or the monetary standard of that country. If only one metal is adopted as standard of value, the system is known as single standard or monometallism. If the metal so adopted is gold the monetary system is known as a gold standard system ; if it is silver, it is known as silver standard system. If the currency is simultaneously linked to two metals—gold and silver—the system is double standard or bimetallism. In case the currency is not linked to any metal it may be called paper standard or managed money.

Gold Standard

Gold standard means that the currency of a country is linked to gold, *i.e.*, gold is the monetary standard or the standard of value. The currency derives its value from gold as it is linked to it. But it can be linked to gold in different ways, and therefore there are different kinds of gold standard—(1) full gold standard or gold currency standard; (2) Gold bullion standard and (3) Gold exchange standard.

Gold Currency Standard

Under this system the standard coin is a full-weight gold coin, freely minted and there is no restriction against its melting or export. It does not mean that the entire currency may consist of gold coins alone. The rest of the currency may consist of tokens, both metallic and paper, but the tokens are legally convertible into the standard coin at a fixed rate. They are multiples or sub-multiples of the standard coin and derive their value from the standard coin. This system is claimed to work automatically and is said not to require any management. It is also claimed that under it the internal and externel value of currency remains stable. It is claimed that due to perfect elasticity of currency under it the quantity of currency always adjusts to its varying needs and therefore its value is not allowed to fluctuate widely.

For example, if at any time the need for currency increases its value will tend to rise and consequently the money value of the standard gold coin will become higher than its intrinsic or metallic value. This will at once lead to a demand for more gold coins. People will present gold to the mint and demand gold coins in exchange. More coins will thus come into circulation and the quantity of currency will expand until it has become equal to its increased demand ; and then its value will again be at par with that of gold. Similarly if at another time the need for currency is reduced or there is less demand for currency, currency will automatically contract. With a decrease in the demand for currency its value will become lower than the value of gold contained in it. People will melt the gold coins and the melting will continue until the amount of currency is reduced to the extent of its reduced demand. It is therefore said that this automatic quality of expansion and contraction of currency according to its varying needs keeps the value of currency stable and to that extent the internal price-level stable.

In the matter of the external price-level also gold standard secures stable rates of exchange between different gold standard countries. For between them due to free export and import of gold, the rates of exchange cannot fluctuate beyond the narrow, fixed limits set by the gold or specie points.[1]

Gold Bullion Standard

Under gold bullion standard the currency consists entirely of tokens, but the tokens are convertible into a fixed quantity of gold bullion without any restriction or limit. Gold bullion standard is gold standard as much as gold currency standard. The only difference between the two is that under it gold is not minted into coins but is kept in the reserve for converting the currency into gold.

In this case also currency is said to expand and contract according to its varying requirements and thus its quantity or supply adjusts itself to its varying demand and thus its value remains stable. For if at any time the demand for currency increases and its value therefore rises, people demand currency from the currency authority in exchange for the statutarily fixed quantity of gold and thereby currency expands ; while if at another time the demand for currency becomes less and its value falls people present currency to the currency authority and demand gold in exchange and thus currency contracts. Such an automatic expansion and contraction of currency, it is claimed, keeps its value stable and does not allow price-level to fluctuate widely.

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[1] See chapter on "Foreign Exchanges".

In the matter of foreign exchanges also the rates of exchange cannot fluctuate beyond the narrow limits of the specie or gold point. For the free outflow and inflow of gold would not allow the rates of exchange to rise or fall beyond the cost of transport of gold.

Both Gold Currency Standard and Gold Bullion Standard are however very expensive monetary systems as they require a large amount of gold, which is a very costly metal for maintaining these systems. Many countries which could not afford to incur such heavy costs adopted a substitute for these which is known as Gold Exchange Standard.

Gold Exchange Standard

Under this system the currency of a country consists entirely of tokens which for internal purposes are not convertible but are convertible into a fixed quantity of gold for purposes of foreign exchanges, hence the name exchange standard. Here the currency is linked to gold not directly and for all purposes as in the above case but only through foreign trade. This system is much more economical as it requires comparatively a much smaller gold reserve for its maintenance.

Under it the expansion and contraction of currency coming through foreign trade are therefore belated. It is also a complicated system and the linking of currency to gold is not conspicuously visible to the layman, it therefore does not inspire the same confidence as the two earlier mentioned systems do.

Since the expansion and contraction of currency take time, fluctuations in the value of currency are wider and last longer than under gold standard proper, and consequently the internal price-level is less stable. Though the external value of the currency remains as stable under it as under gold standard because of the availability of gold at a fixed rate for foreign payments. Here also therefore the rate of exchange cannot fluctuate beyond the limits of the cost of transport of gold or the two specie or gold points.

An Automatic Standard

The claim that gold standard is an automatic standard which does not need any management or in other words, that the currency under it is not managed currency and is therefore both 'fool proof' and 'knave proof' is not justified by the actual working of the system and its history in countries which adopted it. Even gold standard currency requires management for its proper working. There are as it is said certain 'rules of the gold standard game'. These rules must be followed if gold standard is to work successfully without breaking down. These rules are chiefly two ; one, that gold movements are allowed to exercise their full influence on prices and second that the financial and commercial policies of gold standard countries should not hinder the adjustments of balances of payments and the real transfer of net payments. According to the first rule the central bank or the currency authority should allow and not restrict the fullest expansion of currency to the extent of the inflow of gold into the country. In fact the central bank should deliberately expand credit to the extent of the inflow of gold. And when gold flows out credit to that extent should be contracted. According to the second rule the creditor countries should not in anyway restrict or interfere with the excess of imports over exports. They should allow a free inflow of goods by which the debtors would be paying their debts and by tariffs, etc., should not cut down imports.

Breakdown of Gold Standard

These rules were not observed by the gold standard countries during and after World War I. Almost all the countries violated these rules, they neither allowed the gold movements to exercise their fullest influence on credit and consequently on prices and in their anxiety to increase exports they restricted imports and adopted number of ways to discourage imports. With narrow nationalistic outlook and policy the working of an international standard as the gold standard became impossible and it broke down.

So we see that even a gold standard is not entirely automatic, it also requires management and it is so expensive to boot. Moreover it takes away a country's freedom in its monetary policy and management. Why not therefore have an inexpensive monetary system and manage it in the best interests of a country. If management is necessary for all monetary systems it is certainly better to adopt an inexpensive one. Moreover the value of gold is not always the same, and sometimes its value fluctuates very widely. These fluctuations would naturally be reflected in the value of the currency which is linked to it. Again if all the world adopted gold standard the supply of gold will fall far short of the monetary requirements and will cause security of gold and a great rise in its value.

Managed Money

This is a system of currency or monetary standard where inconvertible paper money circulates and where it is managed by the central bank according to a definite plan of monetary stability. In this case the central bank has sufficient freedom to manage currency unhampered by the necessity of either acting in unison with other countries or keeping gold reserves and adjusting currency to gold or gold to currency. Moreover the system is very economical. Experience shows that the system has been worked successfully and both internal and external stability of prices has been achieved. Prices were comparatively more stable in England during 1931-36, after it went off gold standard than in France during the same period when it was on gold.

There are some people who recognize the defects of gold standard but who regard a paper standard even worse. They claim that a double standard is more conducive to efficiency than a single standard and they advocate bimetallism.

Bimetallism

Bimetallism or double standard is a monetary system under which instead of one metal, gold, two metals gold and silver, simultaneously adopted as standard of value or monetary standards. That is, instead of currency being linked to merely gold, it is linked to both gold and silver at the same time. Under bimetallism there is free coinage of both gold and silver at a fixed mint ratio. Thus under it there are two full-weight, freely minted standard coins--one of gold and another of silver—which circulate at a legally fixed ratio and both of which are unlimited legal tender. Anybody has the right to bring to the mint gold or silver bullion and have it manufactured into coin without limit of quantity. And every debtor has the right to pay his debts either in gold coins or in silver coins and without any limit. The mint ratio or the ratio at which the two coins are coined by the mint and circulate as money conforms to their values as bullion also. That is, the mint ratio and the market ratio of the two metals cannot under bimetallism differ for any length of time. There is tendency under it for the automatic maintenance of gold-silver ratio. This is called the compensatory action of bimetallism.

Compensatory Action of Bimetallism

Through the compensatory action of bimetallism the market ratio of gold and silver bullion conforms to their legally fixed mint ratio. A very simple hypothetical example will show how it will be. Suppose the two standard coins contain 1 ounce of gold and silver each ; and suppose their mint ratio is 1 to 20, *i.e.*, one gold coin is equal in value to 20 silver coins. If at any time the market ratio varies from this 1 to 20 ratio it will soon enough conform to it through the compensatory action of bimetallism. If at any time the market ratio differs it will make either gold or silver cheaper undervalued. Gresham's Law will operate and the overcomes 1 to 19½. This means that silver has become dearer in the market and gold cheaper but the mint ratio which is fixed by law is 1 to 20 and consequently as compared with the market, gold is overvalued at the mint and silver is undervalued. Gresham's Law will operate and the overvalued metal will drive the undervalued out of circulation, *i.e.*, more and more gold will be presented to the mint for coinage and silver coins will be melted. This will on the one hand increase the supply of silver bullion in the market and on the other increase demand for gold bullion. The value of gold will consequently rise and of silver fall, until their ratios in the market become the same as at the mint ; for, so long Gresham's Law will be in operation. The same will happen if silver were overvalued at the mint, then more and more silver will be presented for coinage and gold coins will be melted which will increase the supply of gold bullion in the market and increase the demand for silver.

Advantages of Bimetallism

The advocates of bimetallism claim a number of advantages for this system and regard it superior to monometallism or a single standard system. (1) It is said that under bimetallism there will be greater stability of prices than under gold standard. In the case of gold standard the value of currency depends entirely on the value of gold. The supply of gold may not always be steady and its value therefore may at times fluctuate widely. If both gold and silver are used as monetary standards an increase or decrease in the production of one metal may be compensated by the opposite movement of the other. The total supply of the two metals may be more steady than of one. (2) The danger that there will be scarcity of gold if all the countries adopted gold standard will be minimised if both metals are used, as their combined supply will not fall short of monetary requirements. (3) If bimetallism is adopted by all or most of the countries of the world, the fall in the price of silver would be checked, it would even rise as the demand of silver for monetary use will increase. The rise in the price of silver will increase the purchasing power of the silver using countries and will increase their demand for goods and will thus check depression. (4) If most countries adopted bimetallism there would be greater stability of foreign exchanges between gold and silver using countries. Greater stability of rates of exchange between different countries will stimulate foreign trade and would also check depression.

Its Defects

The abovementioned advantages of bimetallism are in fact plausible, they are more apparent than real. Regarding, for instance, the stability of prices what guarantee is there that when the output of one metal increases that of the other will decrease or *vice versa*. It is quite possible that the output of both may increase or decrease at the same time and the value of both the metals may rise or fall simultaneously. Again in spite of its compensatory action it may not be possible to maintain the mint ratio in the face of a changing market ratio. If the variation in the two ratios at any time is large the overvalued metal may entirely displace the undervalued and there may be either only gold or silver standard. Alternately the metallic money may consist of overvalued metal alone. "If there is a considerable and sustained variation between mint and market valuations, this process will work itself out very quickly; the cheaper or overvalued metal will displace the other in a very short time."[1]

If however, most of the countries of the world adopted bimetallism, there would be a greater possibility of keeping the ratio between the two metals stable. International bimetallism may work out seccessfully to some extent, but international bimetallism does not seem to be a practical proposition. The entire world has never agreed to any single monetary system and it is not likely to in the future.

But the worst defect of bimetallism is that it would introduce a lot of confusion in business transactions, besides complicating the mechanism of exchange and necessitating the management of a currency tied to two metals instead of one. Whenever any metal becomes overvalued (at the mint) the debtors would want to receive payment in the other. This will disturb credit and introduce an element of uncertainty in exchange. During periods of disparity between mint and market ratios there would naturally be a lot of speculation in the bullion market and speculators may hold the cheaper metal with a view to taking advantage of a later rise in its price which would naturally delay the adjustment of the ratios.

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[1] Taussig, *Principles of Economics*, p. 264.

CHAPTER XXXI

FOREIGN EXCHANGE

Meaning of Exchange

"AN exchange in commerce is where a person pays his creditor by transferring to him a debt due to himself from some one else."[1]

Let us take an example. Suppose a person X in Cawnpore is debtor to a person Y in Lucknow, and another person A in Lucknow is debtor to another person B in Cawnpore for a similar sum. In order to pay their debts, X will have to send money to Y and A will have to send it to B. This will mean two separate transmissions of money between Lucknow and Cawnpore, at some expense.

Now this expense can, to a great extent, be saved and the settlement of debts to a great extent facilitated if X in Cawnpore goes and pays his debt to B and takes from B the debt due to him from A, and send it by post to Y, who goes to A and demands payment of the debt. Here we see that both the transactions have concluded without any actual transmission of money between Lucknow and Cawnpore.

Post Office as an Agency

The above case may be too solitary, but in actual practice we find innumerable transactions being concluded on the same principle without the actual remittance of coins or bullion. But where transactions are many and when parties to transactions are not known to each other, there arises the necessity of some intermediary agency to bring about the desired result. The most well-known agency for this purpose is the post office. We know how money is sent from one place to another by means of the money order. The post office, by charging us a small fee, undertakes to take our money to the person to whom we want to send it in another city. And this service the post office renders to all who have money to send and who are prepared to pay the fee. Now there are so many people who are daily sending money from one place to another and *vice versa*. The post office does not actually carry all the bullion or coin from place to place, but what it does is that it pays the payees of a place from the money that it has received from the remitters of that place. The only thing which is sent is the money order form.

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[1] *The Elements of Banking,* **Macleod, p. 177.**

Exchange through Bills, Cheques, etc.

This is one system of the transfer of obligations from one place to another; there are various others. Money is sent from one place to another by means of cheques, bills of exchange, bank drafts and *hundis*. And here it is the banks who act as intermediary agencies like the post office. But whatever the system may be, the principle is the same and the aim of all of them is to economise time, trouble, and expense, and obviate the risk which is involved in sending large sums from one place to another.

Foreign Exchange

So far we have seen how exchange transactions are carried on in one country; and this we may call Inland Exchange. Foreign exchange is not different from inland exchange in principle. Foreign exchange is simply an extension of the internal credit system to the wider field of international settlement. Or in other words, foreign exchange is the mechanism for the settlement of indebtedness between different countries.

Example of Foreign Payments

Taking a very simple example of how international indebtedness is settled without the actual transmission of specie or bullion, we may suppose that a merchant X in Bombay sends cotton worth Rs. 500 to a merchant Y in London, and draws a Bill upon him for the amount. Another merchant A in London has sent goods worth Rs. 500 to a merchant B in Bombay. Both Y in London and B in Bombay have to send Rs. 500 each so as to reach their creditors on say, the 31st December. Now instead of B sending money to London and Y to Bombay, B meets X, pays him Rs. 500 and takes X's Bill on Y which he sends by post to his own creditor A, who presents it to Y and receives Rs. 500. Thus we see that both the creditors have got their money and both the debtors have made their payments, and no bullion or gold has passed from one country to another.

Foreign Bill of Exchange

In actual practice, however, there are numerous merchants and others in India who have to send money to London and *vice versa*, and since all of them are not known to one another nor all have to pay or receive an equal amount on one day, there arises, as in the case of inland exchange, the necessity of an intermediate agency, or the middleman. These middlemen are the various banks and bill-brokers, etc., who deal in foreign exchange business.

They make it possible through the instrumentality of the bill of exchange (foreign) that innumerable trade and other transactions between different countries are liquidated without the shipment of gold or bullion. The bill of exchange thus plays an important part in the exchanges of large amounts, which international commerce makes payable in one place or another.

The mechanism of foreign exchange is a bit more complicated than that of inland exchange. The complication is due to the existence of different kinds of money in different countries. If all the countries of the world were to have the same money, foreign exchange transactions could be as simple as inland exchange transactions.

Conversion of One Money into Another—Rate of Exchange

In the process of settling international obligations, the first thing is to convert the money of one country into its equivalent in the money of other countries. Every country has adopted some special monetary unit of its own. France has the franc, England has the pound, U.S.A. has the dollar, Germany has the mark and so on. All these coins, though of gold, are of different weight and fineness. If payment has to be made to another country, it has to be made in the currency of that country. So that any payment from one country to another involves a translation or conversion of an amount of one currency into its equivalent in the other. The rate at which the unit of one currency will at any time exchange for another is called a rate of exchange. Or, in other words, the rates of exchange are the prices at which the currencies of the various countries are expressed relatively to one another.

Mint Par of Exchange

But how is this rate to be determined? The rate is determined by establishing a relation between the amount of pure metal in the standard coins of different countries. It has to be ascertained how much pure gold each coin contains; and the proportion of pure gold in two coins is the basis of changing one money for another. This basis is called the 'Mint Par of Exchange', and it may be defined as, "the exact equivalent of the unit of currency of one country expressed in terms of the currency of another, the relation being determined by a comparison of the quantity and fineness of the metal contained in the respective coins as fixed by law."[2]

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[2] *Elements of Economics*, Thomas, p. 508

Determination of Mint Par

Thus knowing that a £ contains 7·32239 grammes of pure gold (7·98805 grammes 11/12th fine) and a Napoleon (20 francs) contains 580645 grammes of pure gold (6 ; 45161, 9/10 fine), we can easily calculate how many francs are equal to a pound or what is the mint par of exchange between London and Paris. It is 25·2215 francs.[3] Similarly we can calculate the mint par of exchange between London and other countries. The following are a few mint pars between London and the countries noted :—

France	..	124·2134	Franks	=	£ 1
Germany	..	20·429	Reichsmarks	=	£ 1
Italy	..	92·46	Lire	=	£ 1

Mint Par the Basis of the Rate of Exchange

The mint par of exchange is, as we have seen, only the basis of the rate of exchange. It is not the rate of exchange itself, which is changing from time to time. Mint par of exchange, on the other hand, is fixed ; it cannot vary unless the metal contents of one of the coins are altered. It should also be remembered that there can be no mint par of exchange between two countries possessing standard coins of different metals. Thus there cannot be any mint par of exchange between England, a gold standard country, and China, a silver standard country.

The Gold Points

The rate of exchange, as has been said above, is fluctuating. It fluctuates above or below the mint par. But it does not usually fluctuate indefinitely ; it fluctuates within certain limits below or above the mint par. These points beyond which the rate of exchange cannot go, are called the 'Gold points' or 'Specie points'. The upper point is called the upper gold or specie point and the lower, the lower gold or specie point. The rate of exchange constantly fluctuates between these two points, but cannot fluctuate beyond them. The gold or specie points are determined by the cost of transporting gold between two countries. Gold will be remitted from one country to another only when there is no other less expensive way to settle the debt. And when the remittance of gold is cheaper than settling the debt in any other way, people will send gold rather than adopt any other way. Thus we find that if exchange rate has a tendency to rise or fall above or below the specie points, it at once brings about an outflow or inflow of gold, which reduces the demand for foreign exchanges and thus keeps the rate of exchange between the two specie points.

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[3] This was the mint par before the War. After the War. France has decreed that the Franc shall have a gold basis of 65·5 milligrammes, nine-tenths fine. The pure gold contents of one franc is thus ·05895 grammes which gives a new mint parity of **124·2134 francs to the £.**

Exchange at Par

We know in modern times every civilised country is in trade relation with another. Every country has goods to send to other countries, and is in need of goods from other countries. Thus each country has its imports and exports, for no country can go on importing goods unless it has something to pay those imports with, and it pays the imports with goods which it itself produces and exports. Thus we see that the exports of a country go to pay for its imports ; and if the money value of the exports and the imports is equal, the bills of exchange exactly liquidate the transactions, for the bills drawn by the exporters will all be purchased by the importers and sent to their creditors in the foreign countries. Under such circumstances, exchange is in an equilibrium state and is said to be at 'par', and no specie will flow from one country to another.

Exchange at Discount

But it is not necessary that the money value of the exports and imports of a country should always be equal ; there may be a difference between the two and there may thus be a balance of indebtedness on one side or the other. Now suppose a country has exported more than she has imported. This means that the country has more money to receive than to pay, and also means that there will be more exporter's bills than the importer's need, so that all the bills will not be sold and some will be left out. Now those exporters who have not been able to sell their bills, can only get their money by sending for specie from the debtor country. This, however, involves expense. The specie must be checked, boxed, insured and transported. And when it reaches the exporter, he has to convert it into money, which may take time. So that, to avoid all this trouble and expense the exporter will be willing to sell his bill at a little less than its par value. The amount of reduction to which he will submit can only be upto the amount of the cost involved in transporting specie. Thus exchange rate or the price of bills can fall to the specie importing point or the lower gold point ; and if foreign exchange is at this point ; specie will begin to flow in, for at this point it is immaterial to the exporter whether he sells his bill or imports specie, and below this point he will be positively at a loss to sell his bills. We assumed that a few exporters only were left with bills unsold and that they will in order to sell the bills have to reduce their price or send for specie. It will not only be these few who will have to sell their bills at a lower price, but all the exporters will have to do so; as there being active competition amongst them all, no one will be able to sell his bills at a higher price. Under these conditions the market rate for bills, when there is a continuous excess of exports, will be at the specie importing point, and exchange in the exporter's country will be at a 'discount'.

Exchange at a Premium

The reverse will be the situation when imports exceed exports. In this case the importers will need more bills than the exporters can supply; and consequently some of them will have to send specie and this again involves the same sort of expense as bringing specie in. The result will be that the price of the bills will go up, but it can go up to the extent of the cost of sending specie out. The point to which it will rise, therefore, will be the specie exporting point or the upper gold point. The exchange in this case will be at a 'premium'.

Dealers in Foreign Exchanges

In the above example we have assumed that all the bills are sold and purchased directly by the exporters and the importers. In actual practice, however, it is not so; there intervenes a class of middlemen, who deals in foreign exchanges and who is a specialist in this line. These middlemen buy bills from the exporters and sell them to the importers. They are thus constantly buying and selling, and they raise or lower their rates as the bills offered are more or less than needed. In the case of the exporters' selling their bills directly to the importers we said that the discount or premium was to the full limit or that the exchange was either at the upper or at the lower gold point. But with the presence of the dealers the discount or premium may be well within these limits. For in their case the anticipations of the future play an important part. If they get more exporters bills they may not sell all, but in anticipation of the future increase in the demand for bills, may hold back some; and *vice versa*. The result will be that bills will be sold at prices somewhere between the two specie points.

Banker's Bill

But besides the bills drawn by exporters there are bills which are drawn by bankers on their foreign correspondents. These are known as Banker's Bills and sell for a somewhat higher price than most mercantile or trade bills. Now in times when there may be a greater demand for bills than the exporters can supply, the banker's bills can be available, and thus obviate the necessity of transmitting specie. Again in the case of certain countries, chiefly agricultural countries, we find that their staple export is harvested at a certain season, when they may take payment for it in gold, and will have during the rest of the year to remit in gold for the goods and services that they buy from other countries. "But the dealers in exchange, and the more legitimate class of finance bill, provide the means by which, at times when such a country has nothing to export, the exchange dealers will make good profits by creating bills against nothing, but in anticipation of the crop that is in the ground, with the result that the country exports less gold in its off-season, and imports less when its crop is ready."[4]

Settlement of Debts through a Centre

We may as well note here that it is obviously advantageous to the commercial world that some centre should be chosen by mutual consent where bills can be made payable, and where debts can be settled. In modern times, London has been chosen as this centre, and bills drawn on London find a ready market in all parts of the world. Bills drawn on and payable in London, are readily accepted because London for a long time has been the financial centre of the world and British finance has acquired a reputation that inspires confidence. But this should not mean that all bills are drawn on London, though it is a fact that London draws few bills but accepts many. This arrangement is preferred both by foreigners and by the British traders. A London bill is easily bought and sold.

Demand for and Supply of Foreign Bills

Foreign bills are bought and sold at various financial centres and their value is determined, like other commodities, by their demand and supply. If the demand for bills drawn on a particular centre is greater than the supply, their prices rise; it falls if the demand is less than the supply. The supply of bills depends on the number of merchants who have sent out goods from the country and have bills to sell; the demand for bills depends on the number of merchants who have bought goods from foreign countries and must buy bills to make payment. In other words, the supply of and demand for bills shall depend on the balance of export and import for the country. If a country's imports are greater than her exports, the rate of exchange will rise against it or will be unfavourable ; and if its exports are greater than her imports then the rate of exchange will fall or will be favourable to the country.

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[4] *The Meaning of Money*, Withers, p. 192.

Quotation of Rates of Exchange

Before considering what really a rising and falling or a favourable or unfavourable rate of exchange means, let us first see how the exchange rates are quoted. Every rate of exchange can be quoted in two different ways. It can be expressed either as the amount of home currency which must be given in exchange for the standard coin of the other country, or as the amount of the foreign currency which will be received in exchange for the standard coin of the first country. The rate between India and England may be quoted either in so many shillings which can be exchanged for a rupee, or so many rupees which will be paid for a sovereign ; or taking the case of England and France, the rate may be quoted either in Francs, *i.e.*, the number of Francs available for a pound, or it may be expressed as the number of pence equal to one franc. It is immaterial in which of the two currencies the rate is quoted but it has, nevertheless, to be remembered in order to understand whether a rising rate or a falling rate is favourable or unfavourable.

Rising and Falling Rates of Exchange

In case the rate is quoted in the foreign currency it means the amount of that currency available in exchange for a certain amount of home currency, *e.g.*, the rate of exchange between India and England is say 1*s.* 6*d.* ; it means that every rupee will exchange for 1*s.* 6*d.* of the English currency. Now supposing that the rate were to rise from 1*s.* 6*d.* to 1*s.* 6¼*d.* we would find that more of English currency is available for a rupee or in other words, the rate is favourable to India. And if the rate were to fall to say 1*s.* 5¾*d.* there would be less of English currency available for a rupee and the rate would be unfavourable to India. Now the rising rate which was favourable for India will be unfavourable for England, and a falling rate which was unfavourable for India will be favourable for England. The reverse will be the case if the exchange rate was quoted in Indian currency instead of English currency. So that we see that when rates are quoted in foreign currency high or rising rates are favourable to the home country, and low or falling rates are unfavourable. While when the rates are quoted in the home currency, high or rising rates are unfavourable, and low or falling rates are favourable.

For the sake of convenience and in order to avoid confusion we may tabulate our statement in the following form :—

Where the currency is	And the quoted figure is	The rate of Exchange is
Foreign	Falling	Unfavourable
Foreign	Rising	Favourable
Home	Falling	Favourable
Home	Rising	Unfavourable

When the exchanges with any particular centre are favourable to a country, the rate is tending towards the lower or gold importing point, while it is tending to the upper or gold exporting point if the rate is unfavourable. Or in other words, "if there is a general excess of imports over exports, foreign exchange is at a premium, and specie tends to flow out ; while a general excess of exports brings exchange to a discount and causes an inflow of specie. [5]

Outflow and Inflow of Gold

We have seen earlier that it is not always necessary that the imports of a country may equal its exports. And in cases where it is not so, there remains a balance of indebtedness to be met in some other way. The other way is by exporting gold or specie. Now a country, unless it is a gold-producing country, cannot indefinitely go on exporting gold ; its stock of gold must sooner or later exhaust. How is it then to pay its balance of indebtedness ? Or we may put the question in another form as Prof. Taussig puts it, "suppose, now, that the total exports do not suffice to pay for the total imports. Then they must be paid for in specie. Will that specie flow out for an indefinite time, and what likelihood is there that a balance will permanently remain to be paid in this way ?"

Effect of Movement of Specie on Prices and Rate of Exchange

The answer to the question is that the flow of specie itself creates forces which check its flow. When specie is exported from a country the quantity of money in that country becomes less and consequently prices fall. With a fall in prices, exports increase and imports decrease, for foreigners will be willing to buy more and sell less at lower prices. While in the country to which specie was flowing prices will rise and decrease exports and increase imports. Thus we see that the flow of specie has an automatic limitation, and in consequence of the effect of the quantity of money on prices, merchandise exports and imports in the long run balance one another.

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[5] *Principles of Economics*, Taussig, p. 457.

Effect of Fluctuation in the Rate of Exchange on Prices

Besides the effect of a flow of specie on prices, the fluctuations in the rate of exchange directly effect the exports and imports. A rise in the rate of exchange against a country means that the importers in that country must pay a little more for their bills, which comes to the same thing as paying a slightly higher price for the goods imported. While exporters receive a little more for their bills. In other words, such a rise in the rate of exchange is a penalty on imports and a premium on exports. The imports will consequently be checked and exports encouraged, which will go to restore the balance of trade.

Regulation of Discount Rate

Besides these automatic compensating actions of the exchanges and the flow of specie, there are certain artificial devices resorted to in order to check an outflow of specie. The most effective and familiar among these is regulation through Discount Rate. When specie flows out of a country, it comes ordinarily from the bank reserves. The banks, in order to maintain their reserves, raise the discount rate. Since gold has a free market and is free capital, it tends to flow to the place where the return on loanable funds is largest. A rise in the interest and discount rates of a country, therefore, begins to attract funds from other countries. Foreigners begin to invest their capital in this country and those who have payments to receive wait and try to take advantage of higher rates. Thus an outflow of specie is checked and instead an inflow may begin.

Fluctuations in the Rate of Exchange

In normal times fluctuations in the rate of exchange are small ; and if there is a free outflow and inflow of gold, the rates cannot fluctuate beyond the two specie points. The changes in the rate of exchange are due chiefly to changes in the demand for and supply of bills. The greater the demand for bills the higher will be their price and *vice versa* ;

and if the demand is strong enough the price will go up until the point is reached where it is equally profitable to send gold. Gold will be sent if it is available in sufficient quantity, but if there are restrictions on its export, there is no limit to which the rate of exchange may rise or fall.

Influences causing Fluctuations

The various influences which may cause fluctuations in the rate of exchange are the following :—

(1) *Trade Conditions.*—An excess of imports over exports tends to turn the exchanges against a country and an excess over imports has the reverse effect. An excess of imports means a greater demand for foreign currency and consequently the price of foreign currency (or foreign bills) rises ; while an excess of exports lowers the price of foreign currency. Exports and imports should not only include goods, but also services (such as shipping, insurance, banking, etc.), which one country renders to another ; and their payment influences exchange rates in the same way as payment for goods does.

(2) *Stock Exchange Influences.*—These include investments and speculation in international stock, and the issue of foreign loans. If one country invests money in the securities of another country, or if it lends money to the other country, it acquires the right of withdrawing funds from the other country, and this depresses the value of the currency of the other country. The raising of a loan in another country has the effect of a flow of funds from the other country, and if the loan is for a large amount, it may produce appreciable effect on the rate of exchange.

(3) *Banking Influences.*—These include the investments by bankers of funds in other countries, the issue of circular notes and letters of credit and the undertaking of arbitrage operations. Banks deposit their funds in foreign countries or buy foreign bills, whenever they find it profitable to do so. These bills, in some cases, the bankers keep till maturity, while, in others, they sell them at once. Thus by their sale and purchase of bills they influence to a great extent their supply and demand and thus affect the rate of exchange. The issue of circular notes and letters of credit, etc., influences rates against the country of the issuing banks, as they increase the supply in other countries of claims upon the country of issue.

Arbitrage Operations.—Arbitrage Operations consist of the buying and selling of foreign currencies with the object of making profits out of the differences existing between the exchange rates at different centres at the same time. It is a form of speculation in differences, and the profits are made through the differences in price which may exist in various centres.

(4) *Currency Conditions.*—So far those influences have been discussed which affect the rate of exchange through the demand for and supply of bills, but there are other influences also which cause fluctuations in the rate of exchange. The condition of the currency of a country has a great influence on the rate of exchange. A debased or depreciated currency will have a low exchange value ; and though an inconvertible paper currency may circulate in the country of issue, its value to another country will be determined by its purchasing power.

Foreign Exchange during War

So far we have considered the state and determination of the foreign exchanges during the period before the last Great War. During the War time serious complications arose owing to different monetary systems in different countries and there was a virtual dislocation of the exchanges. This was due to a very great increase in prices brought about by a great increase in the volume of inconvertible paper money in all the European countries. Various devices were adopted by governments to regulate foreign exchanges but they all failed because of the failure to reduce the amount of inconvertible paper money.

Silver Exchange

So far we have seen how foreign exchange between countries rests ordinarily on the equivalent of different gold coins—pounds, francs, dollars, etc. But all countries are not on a gold basis. Some countries have a silver standard, as China has to-day, and India had until 1893, before the introduction of the gold exchange standard. We have already seen that between two countries, one having a gold standard and the other a silver standard, there can be no mint par of exchange. In such cases the rate of exchange is based on the relation between the value of gold and silver. And thus exchanges between gold-using and silver-using countries depend upon the cost of laying down silver in that centre where payment has to be made.

Fluctuations in the silver exchanges result not only from the ordinary influences affecting the demand for and supply of bills, but also from the changes in the gold price of silver, and the consequent unstable condition of the currency in the silver-using countries. The price of silver fluctuates much more rapidly and to a greater extent than does the price of gold. So that even in normal times the silver exchanges fluctuate very considerably. The compensating action of the exchanges, which goes to correct the adverse exchange rate, has only a part application in this case and works very slowly. We saw in the case of gold standard countries, that any outflow of gold automatically checked itself. An outflow of silver to a country which is on a gold basis, may not produce any effect on the quantity of its currency.

Paper Exchange

Similar, rather more, disturbing effects are produced by inconvertible paper money. Inconvertible paper is generally subject to over-issue, which results in the depreciation of its value even more than the over-issue would warrant. Here again there are two sets of influences on the foreign exchange—the ordinary influences and the depreciation of paper. "The rates not only change rapidly, but become sensitive to rumour and to speculative shift and manipulation. They respond slowly and imperfectly to the fundamental causes that determine their general range. And therewith all international trade with the countries of depreciated paper comes to partake of the nature of gambling."[6]

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[6] *Principles of Economics*, Taussig, p. 464

CHAPTER XXXII

HISTORY OF INDIAN CURRENCY

(1835 to 1913)

The Rupee in 1835

BEFORE 1835 a great variety of gold and silver coins circulated in different parts of India. The circulation of various kinds of coins of several denominations was a cause of very great inconvenience to the trading community, to the general public and to the Government; and created many difficulties in the way of the development of the home and the foreign trade of the country. To remove this inconvenience the East India Company established in 1835 a standard coin throughout the territories belonging to them. The coin so adopted was the present rupee (containing 165 grains of silver and 15 grains of alloy), which was made legal tender, while all other coins of gold and silver ceased to be legal tender from this time.

Gold Coins

Thus from 1835 onwards the rupee became the standard coin of India, and gold coins were no more legal tender. But on account of the continued demand of the people for the use of the gold coins, the public treasuries were authorised in 1841 to receive gold mohurs for Rs. 15. About the middle of the nineteenth century the price of gold fell as a consequence of the Australian and Californian gold discoveries. This embarrassed the Government, as the holders of gold coins obtain from the treasuries larger price in silver for depreciated gold. Consequently the provision of 1841 was withdrawn by a notification of 1852, and gold was completely demonetised in India.

Fall in the Price of Silver

Nothing eventful happened till the year 1873, when the gold value of silver began to fall. The fall in the price of silver became very rapid from 1874 and did not stop for nearly twenty years. The reasons for this fall were a diminished production of gold and an increased production of silver after 1873, and an increased demand for gold for currency purposes and a diminished demand for silver for the same purposes.

Discovry of Mines and Invention of Better Process of Productions

On account of the discovery of new silver mines and new inventions in the process of its production, the production of silver increased by more than 100 per cent. from 1866 to 1835. And during the same period the production of gold decreased by about 25 per cent.

Demonetisation of Silver

The various European countries—France in 1867, Sweden and Denmark in 1873, Holland and Norway in 1875, Russia in 1876, and Austria in 1879—adopted a gold standard. The Latin Union suspended the free coinage of silver in 1874. This resulted in a decrease in the demand for silver and a great increase in its supply. The demonetisation of silver and the adoption of a gold standard increased the demand for gold and led to a further fall in the gold value of silver.

Effect upon India

Such a great fall in the price of silver affected India very adversely. The first effect of this was a fall in the Indian Exchange, from a little less than 23*d*. to a rupee in 1872 to a little less than 16*d*. to a rupee in 1898. An adverse exchange meant the payment of more of rupees for home charges and for interest on foreign debts. The pay of English soldiers in India was paid in sterling, and the exchange rate was fixed by the War Office. This increased the payment in rupees. The European and Anglo-Indian officers were paid an exchange compensation allowance from April 1893. The extent of the loss which India suffered on account of this can be judged from the extra amount of 154 crores of rupees which India had to pay between 1875 and 1895.

Besides this a fall in the price of silver, reduced in value the silver stocks or silver ornaments of the people. A fall in the price of silver led to a great import of silver into India, and a consequent increase of silver currency (on account of free mint) which in turn resulted in a rise in the general level of prices.

Herschell Committee, 1892

To find out a remedy for these disturbing conditions in India, and to devise methods for the stabilisation of the Indian currency, an expert Committee under the presidentship of Lord Herschell was appointed by the Secretary of State for India in the year 1892. The Committee made the following recommendations :

Recommendations

(1) The mints to be closed to the free coinage of both silver and gold.

(2) Rupees to be issued in return for gold tendered at the mints at the rate of Rs. 15 to a sovereign.

(3) The rupee to be a token coin, but was to continue as unlimited legal tender.

(4) The rate of exchange was to be fixed at 1*s*. 4*d*. ; and when the rate reached 1*s*. 4*d*., they recommended the establishment of a gold standard.

The Committee thought that by limiting the coinage of rupees and by making rupees always available for gold at 1*s*. 4*d*., the rate of exchange will be prevented from raising above 1*s*. 4*d*. The object of closing the mints and making the rupee a token was to artificially raise its value. The Committee thus by these measues wanted to secure a stable rate of exchange, and to give to India a currency system, though not consisting of gold, yet capable of working like one under a gold standard.

Action Taken

Immediately after the issue of the report the Government of India, by Act VIII of 1893, closed the Indian mints to the free coinage of both gold and silver, Government retaining the power to coin silver rupees on its own account. By notifications issued at the same time, arrangements were made (1) to receive gold at the Indian mints and pay out rupees in exchange for it at the rate of 1*s*. 4*d*. per rupee ; (2) for sovereigns and half-sovereigns to be received for payment of amounts due to Government at the rate of 15 rupees to the sovereign and (3) for the issue of currency notes in exchange for gold coin or bullion at the same rate."[1]

The Weakness of the System

According to the above Act, while the Government was bound to receive gold in exchange for rupees, it was not bound to give gold for rupees. The absence of gold available for export purposes was the weakness of the system. The result was that the exchange rate did not go up but on the contrary continued to fall with the fall in the value of silver though not to the same extent. Besides this the exchange rate could not as well rise on account of bad harvests in India from 1896 to 1898. After a period of five years from the adoption of the recommendations of the Herschell Committee, the rate for the first time reached 1*s.* 4*d.* But just at this time (1898), another Currency Committee under the chairmanship of Sir Henry Fowler was appointed to consider the future of Indian currency.

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[1] *Money, Banking and Exchange in India*, Jevons, p. 136.

Fowler Committee, 1898

The Fowler Committee had the aim of effectively establishing in India a gold standard and currency based on the principle of free inflow and outflow of gold. With this end in view they made the following recommendations :—

Recommendations

(1) The Indian mints to be thrown open to the coinage of gold sovereigns and half-sovereigns, on the terms and conditions such as governed the three Australian Branches of the Royal Mint ; and the sovereigns and half-sovereigns to be made unlimited legal tender.

(2) The rate of exchange to be finally fixed at 1*s.* 4*d.*

(3) The rupee to continue as a token and an unlimited legal tender. Fresh rupees not to be coined till the proportion of gold in circulation was found to exceed the requirements of the public.

(4) No legal obligation to be imposed on the Government to convert rupees into gold. But for export purposes they advised the government to provide gold as far as possible ; and for this purpose they proposed the creation of a reserve out of the profits of the rupee coinage, exclusively to be kept for exchange purposes.

The Fowler Committee held, and rightly too, that a fixed exchange could only be secured and guaranteed by an effective gold standard. And for this purpose they recommended the establishment of a gold standard with a gold currency.

Action Taken

Almost all the above recommendations were accepted by the Government. The sovereign and the half-sovereign were made legal tender at Rs. 15 and 7½ respectively, and active steps were taken to open a mint for the coinage of gold in India. The gold standard with a gold currency was launched in India, but as we will see below, it was not destined to last for a long time.

Attempt to introduce Gold failed

The first attempt of the Government to introduce gold into circulation was not a success. On account of the improving trade and rising prices of the year 1899 and 1900 there was a great demand for rupees in India. To meet this demand the resumption of coinage became necessary. The situation was further aggravated by a serious famine at the end of the century. In ordinary times the farmer consumes what he produces, but during famines he has to purchase food, etc., for which he requires money. This famine also, therefore, led to an increased demand for rupees. And from 1899 large quantities of gold were tendered to the treasuries and rupees were demanded instead. This led to a decrease of the rupee reserve and to a rapid accumulation of gold, which became a source of embarrassment to the Government. In order to meet the situation the Government began to introduce silver currency and resumed the fresh coinage of rupees.

No further efforts to introduce Gold

Instructions were issued to the currency offices and post offices, etc., to give silver as far as possible. But in spite of these steps the demand for silver continued to increase ; and without taking the peculiar circumstances into consideration it was wrongly concluded that people preferred silver to gold currency, with the result that rupees were pushed into circulation and no further efforts were made to introduce gold into circulation.

Mint for Gold could not be established

The idea of the establishment of a mint for the coinage of gold could as well not be realised on account of the opposition of the British treasury on technical grounds. For this reason and on the ground that there was not any great public demand for gold as currency, the idea was given up in 1902.

Gold Exchange Standard

From this time onwards, the idea of a gold standard with a gold currency being given up, India drifted towards the establishment of what is called a 'Gold Exchange Standard'. Under a gold exchange standard, gold does not circulate, but is made available at a foreign centre for payments abroad. According to this system, if gold is available for the purposes of making international payments at an approximately constant rate in terms of home currency, it is immaterial whether or not gold actually forms part of the internal currency. Such a system, it is alleged, will work successfully if gold does not circulate in the country if the home currency is not redeemable in gold for internal purposes and if there is a machinery for making remittances abroad in gold at a fixed maximum rate and for which gold reserves are maintained abroad.

Advantage of Gold Exchange Standard

The advantage of such a system is that it is cheaper. Since it does not require gold for internal purposes, it economises the use of gold, and is, therefore, suited to countries which are poor and cannot afford to use large amounts of gold for internal currency purposes. So long as the stability of the rate of exchange is maintained the gold exchange standard can work as efficiently as a gold standard, and is at the same time cheaper.

On the above consideration India adopted a gold exchange standard ; and to this effect efforts were made to divert gold away from India, to maintain a gold reserve in England and to keep large stocks of silver in India for coining rupees to pay for Indian exports.

Features of Gold Exchange Standard from 1899 to 1914

The features of the gold exchange standard, as it worked in India from 1899 to the outbreak of the War, were that the rupee was a token and an unlimited legal tender and, so far as the law provided, inconvertible ; the sovereign was also an unlimited legal tender convertible into rupees at the rate of Rs. 15, but formed only a very small part of the internal currency ; the Secretary of State sold bills in London on India which were payable in India in rupees; the Government of India not as a matter of legal obligation but as a matter of practice, sold bills on London, in return for rupees tendered here in India, which were encashed in gold from the reserves held by the Secretary of State in England.

Council Bills

The system of the bills drawn by the Secretary of State payable in India and those drawn by the Indian Government payable in London, is an important part of the gold exchange standard system as it worked in India. India usually has a favourable balance of trade, and has thus to receive gold annually in exchange for her extra exports. But she has to remit large sums annually to England as home charges, etc. The Secretary of State, who has to receive these home charges, etc., draws bills on the Government of India for this amount, and these he sells in London for gold to those importers who have to remit money to Indian exporters. The bills are sent by the English importers to Indian exporters, who get them cashed at the Government treasuries and receive rupees.

Such bills, sold by the Secretary of State, are called the 'Council Bills', which were sold without limit of amount at the rate of 1s. $4\frac{1}{8}d.$ per rupee as a maximum rate ; $\frac{1}{8}d.$ being the cost of transportation of gold from England to India. The unlimited offer of the Secretary of State to sell bills at this rate checked the rate of exchange from rising above this rate, for at a higher rate than 1s. $4\frac{1}{8}d.$ it would be cheaper to send gold bullion than to purchase a bill.

Reverse Council Bills

When, on the other hand, there was an unfavourable balance of trade, or there was a demand for remittances abroad, the Indian Government, as a matter of practice, sold for rupees bills, called the 'Reverse Council Bills', payable in London in gold by the Secretary of State from the gold reserve kept in London by India for this purpose. The reverse councils were sold at a rate not below 1s. $3\frac{8}{32}d.$ per rupee, $\frac{29}{32}$ *d.* being the cost of transportation of gold from India to England. And here also if there was an unlimited offer of reverse councils the rate of exchange could not fall below this rate.

"The system of the Gold Exchange standard, as it evolved in practice, was that the rupee remained the effective coin in circulation, replaced more or less by currency notes; and that for foreign exchange purposes gold was convertible into rupees, or rupees into gold, at the fixed rate of 1s. 4*d*. Although sovereigns circulated to a very small extent in India, the silver rupee had become a token coin representing the fifteenth part of a sovereign."[2]

Profits from Rupee Coinage

One important result of the rupee becoming a token was that the Government began to make a considerable profit on the coinage of rupees, and this large profit went to build up the gold standard reserve. The value of the rupee being fixed by law, did not fluctuate with the changes in the value of silver. With the fall in the value of silver, the coinage of rupees became very profitable to the Government.

It should be noted, however, that the maintenance of the Indian system of currency and finance has depended to a very great extent on the various reserves and balances held by the Government of India and by the Secretary of State.

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[2] *Money, Banking and Exchange in India*, Jevons, p. 149.

Reserves and Balances—Treasury Balances

The more important of these reserves and balances are three, *viz.*, the treasury balances, the paper currency reserve and the gold standard reserve. *The treasury balances* consist of the Government cash held by the various Government treasuries in India, the Imperial Bank and the ready money kept by the Secretary of State in London. The Government of India always needs a considerable amount of ready money for various expenses and disbursements ; and the Secretary of State in London also requires a certain amount of ready money to make disbursements on behalf of India in England. For this purpose cash or till money is kept by the Government with its treasuries, with the Imperial bank and with the Secretary of State.

Each district in India has a district treasury, and each tahsil has a sub-treasury. The land revenue and other taxes collected are paid into these treasuries, and out of them salaries of Government servants are paid and other disbursements on behalf of the Government are made. Wherever there are branches or local head offices of the Imperial Bank, the balances of the Government are kept with them and disbursements are made by them on behalf of the Government. The balances with the Secretary of State are large at the close of the financial year, in order that he may be able to pay the interest charges on the public debt of India which are due early in April.

Paper Currency Reserve

The *Paper Currency Reserve* was established to secure the convertibility of the currency notes issued by the Government of India. The reserve consists of silver coins and bullion, gold and investment securities. Only as much silver coin is held in the reserve as is likely to be needed for any possible demand for encashment of notes in rupees for use within India ; and as much gold is kept as will be sufficient to meet any likely demands for the encashment of notes for purposes of exporting gold from India to other countries. Indian currency notes are not convertible into gold for internal purposes. Since the whole of the currency notes issued is never presented for encashment nor is there any possibility of the whole being presented, the amount of silver and gold in the reserve is much less than the amount of the currency notes issued. It has, therefore, been considered safe to allow a considerable proportion of the reserve to consist of investment securities. Besides these, gold and silver bullion purchased by the Secretary of State on behalf of India and in transit to India is also a part of the paper currency reserve.

The whole of India is divided for the purposes of paper currency, into seven circles, each having its own currency office for the issue and encashment of notes and for keeping a part of the reserve. The seven currency offices are situated in Calcutta, Bombay, Madras, Karachi, Lahore, Cawnpore, and Rangoon. The whole of the paper currency reserve is, however, not kept by all the currency offices, but a part of it is distributed throughout the country, being deposited in 'Currency Chests' kept in the district treasuries, and the branches of the Imperial Bank. This distribution is effected in order to facilitate convertibility of currency notes and to avoid unnecessary transfer of coins.

Gold Reserve—Gold Standard Reserve

As has already been seen above, the Fowler Committee recommended the establishment of a *Gold Reserve,* from the profits on the coinage of rupees, to assist in maintaining exchange. "This principle was adopted by Government; and as soon as coinage was recommenced in 1900, the entire profit was credited to this reserve. On 31st March 1901, it amounted to £3,031,000, all held in India, of which £1,200,000 was in gold. A year later the gold reserve had increased to £3,304,000 ; but by the sale of council bills, the whole of this sum had been transferred to London, and was there invested in sterling securities. The Reserve was held in this form, entirely in London, until 1906 when the rupee branch of the Gold Reserve was established in India, and the name was changed to the *Gold Standard Reserve.* Of the total Reserve which amounted at 31st March 1907 to £16,842,000, £4,000,000 (then Rs. 6 crores) was held in rupees in India."

Financial Crisis, 1907-08

In the year 1907-08 there occurred a severe financial crisis, and the gold standard reserve was very hard hit by this crisis. In all £8,058,000 were withdrawn from the reserve to meet the reverse councils sold for strengthening the exchange value of the rupee.

The summer monsoon of 1907 failed and the exports from India diminished as a consequence. Besides this there occurred a serious financial crisis in America, which resulted in a general monetary stringency all over the world. The result was that there was a heavy fall in the demand for council bills and for some months none could be sold. The Indian exchange began to fall.

Government Measures to meet the Situation

To strengthen a falling exchange the best remedy would have been the unlimited offer of gold for export purposes to those who had to meet their liabilities in England. Those who needed gold would have paid for it in rupees, and thus rupees would have been withdrawn from circulation, and as a consequence the exchange value of the rupee would have risen. But the Government of India did not adopt this course. First of all they refused to give gold from the paper currency reserve for export in larger quantities than £ 10,000 to any individual in one day. British postal orders began to be bought in large quantities to make remittances to London. But the situation did not improve. Ultimately the Secretary of State being unable to sell council bills, released gold from the paper currency reserve in London. This improved the exchange to some extent. In March 1908, it was further decided to make weekly sales in India of sterling bills on London at 1*s.* 3 29/32*d.* The Secretary of State in order to meet these bills had to realise some of the securities belonging to the gold standard reserve. The exchange was strengthened by these measures and owing to a good monsoon, but at a considerable cost. £8,058,000 were withdrawn from the gold standard reserve to meet these bills.

CHAPTER XXXIII

HISTORY OF INDIAN CURRENCY

(1913–1925)

Chamberlain Commission

THE loss to the gold standard reserve, as mentioned in the last chapter, aroused strong public criticism and the Government of India found it necessary to revise the currency policy and for this purpose entered into long correspondence with the Secretary of State. The result of this was that a Royal Commission on Indian Currency was appointed in April 1913, with the Right Honourable Austin Chamberlain as its Chairman. The Commission were asked to enquire into :—

Terms of Reference

(1) The location and management of the general balances of the Government of India.

(2) The sale in London of council bills and transfers.

(3) The measures taken by the Indian Government to maintain the exchange ratio ; specially the location and management of gold standard reserves and the paper currency reserve.

The Commission after a thorough investigation reported in February 1914, and made the following recommendations :—

Recommendations

The stability of the exchange value of the rupee was pronounced to be of first importance to India. This was to be the key of the currency policy of India and the measures adopted by the Government of India in this connection, though were not in accordance with the recommendations of the Fowler Committee, were approved. The ultimate goal of the Indian Currency System, *viz.*, a gold standard with a gold currency as outlined by the Fowler Committee was discarded. The Commission thought that the people of India neither desired nor needed any amount of gold for circulation as currency, and the currency most generally suited for internal purposes, was rupees and notes. It was, therefore, in the opinion of the Commission, not to the advantage of India to encourage an increased use of gold in internal circulation. Under these circumstances a gold mint was not necessary though the Commission had no objection to one to pacify Indian sentiment. The Government were advised to give the people the form of currency they demanded, but the use of notes was to be encouraged and the use of gold was to be discouraged. The essential point to be noted by the Government was that the internal currency thus provided should be supported for exchange purposes by a thoroughly adequate reserve of gold and sterling.

For this purpose the gold standard reserve should be strengthened, and therefore, no limit should be fixed to its amount and the profits on coinage should be credited exclusively to it. The Commission agreed with the Government of India that a larger portion of the reserve should be in actual gold, which should be raised to £15,000,000 and thereafter one half of the total reserve should be in actual gold. This was to be done in the first instance by taking gold from the paper currency reserve in exchange for rupees from the Indian branch of the gold standard reserve, which was to be abolished. In the opinion of the Commission the proper place of the location of the reserve was London. The Commission also advised the Government of India to undertake to sell bills in India on London at the rate of 1*s*. 3 29/32*d*. per rupee whenever called upon to do so.

With regard to the paper currency system, it was suggested that it would be made more elastic. In this connection the adoption of the proportional reserve system was recommended. The fiduciary portion was to be increased at once from 14 to 20 crores, and after that it was to be fixed "at a maximum of the amount of notes held by the Government in the Reserve Treasuries *plus* one-third of the net circulation."

Action Taken

War broke out soon after the report was submitted and, therefore action on the recommendations had to be deferred. But, however, action was taken on the following recommendations :—

(*a*) The abolition of the silver branch of the gold standard reserve.

(*b*) The steps to be taken in case of a fall in exchange.

(c) The giving of facilities for the encashment of notes.

Currency during the War—Great Demand for Rupee—Loss to the Government

"The War of 1914-18 put the currency system of India, in common with those of all other countries to a severe test." With the outbreak of the War there was a feeling of insecurity all round. People began to withdraw their money from the post office savings banks and currency notes were continuously presented at treasuries for encashment. All this led to a great demand for rupees. Not only this but our exports increased and imports fell ; the favourable balance of trade was not paid in gold as the belligerent countries did not wish to part with their gold. Heavy disbursements were also made by the Indian Government on behalf of the Imperial Government to finance the Eastern theatres of the War. The intense demand for exports raised prices ; and there was a demand for much greater quantity of currency. The Secretary of State could not send gold to India, but sold council bills in large amounts. These were presented at the Indian treasuries for encashment into rupees, and thus further increased the demand for currency. Internal currency had to be in some way provided. But its provision became the source of a very great loss to the Government on account of the unprecedented rise in the price of silver. When the price of silver was 43*d.* per ounce, the face value of the rupee and the value of the silver contained in it were just equal. Any rise in the price of silver above this would make the coinage of rupees possible at a loss. But the price of silver rose much above this limit ; so much so that it went up to 78*d.* per ounce by December 1919. Rupee coinage was thus carried on at a heavy loss to the Government.

Measure to meet Greater Demand for Currency

The Government did all that they could to provide additional currency. More rupees were coined (132 crores of rupees were put into circulation in four years from 1916 to 1919), more of paper currency was issued against gold securities held by the Secretary of State in London, the fiduciary portion of the paper currency reserve was increased from 14 crores in 1914 to 120 crores by 1919, notes of smaller denominations—2½ rupee and 1 rupee notes—were issued, and 8, 4, 2 and 1 anna nickel pieces were issued to economise the use of silver.

But in spite of these measures the demand of people for more and more currency could not be satisfied. The Government could not, under the circumstances, continue their unlimited offer of rupees at the long established rate.

They had, therefore, to allow the rupee, "so long anchored at 1*s.* 4*d.*, to break loose from its moorings and follow the course of silver prices." The result was that the rate of exchange began to rise and reached 2*s.* 4*d.* in December 1919. The rate of exchange rose but the demand for currency did not decrease. The Government could not now increase the currency, as they had already crossed the safety limit in issuing paper currency and they could not go further.

Babington Smith Committee

It was to tide over this difficulty that expert advice was needed ; and in May 1919, a Currency Committee under the Chairmanship of Sir Henry Babington Smith was appointed by the Secretary of State. The Committee was appointed to examine the effects of the War on the Indian exchange and currency system and upon the position of the Indian note issue, and to recommend improvements with a view to ensuring a stable gold exchange standard. The Committee were thus precluded from considering any alternative standards of currency but to confine their attention only to the re-establishment of stability under the then existing exchange standard.

The Committee made the following main recommendations :—

Recommendations

(1) That the rupee, unchanged in weight and fineness, should remain unlimited legal tender.

(2) That the rupee should have a fixed exchange value at 2*s.* gold.

(3) That the sovereign should be legal tender in India at the rate of Rs. 10 to one sovereign.

(4) That the import and export of gold into and from India should be freed from Government control and that a gold mint should be opened at Bombay for the coinage of sovereigns from gold tendered by the public.

(5) That the Government should withdraw the undertaking of giving sovereigns for rupees.

(6) That the gold standard reserve should contain a considerable proportion of gold and the remainder of the reserve should be kept in securities, maturing within twelve months and issued by Governments within the British Empire (other than the Indian Government) ; and a portion of the gold held in the reserve, not exceeding one half should be held in India.

The Committee, in order to safeguard the token character of the rupee, and thinking that the price of silver would remain high for some time, recommended the stabilisation of the exchange at 2*s*. (gold). To further safeguard against a fluctuation in exchange they recommended that during periods of exchange weakness, the Government, without referring to the Secretary of State, should sell weekly a stated amount of reverse councils.

Action Taken

The recommendations of the Committee were accepted by the Secretary of State. Immediately after this there arose a keen demand for remittances to London. The Government offered reverse councils at 2*s*. gold. "The attempt to hold the rate at 2*s*. gold was not successful ; and the Government thereupon tried, with effect from the weekly sale on the 24th of June 1920, to maintain it at 2*s*. sterling. This attempt also failed, and was abandoned on the 28th September. The Government of India at this period were unable to contract currency in India at the pace at which world prices were falling. All they could do was to avoid further inflation and to effect some measure of contraction. This was insufficient to arrest the falling tide of exchange, which early in 1921 fell below the low level of 13*s*. 3*d*. sterling and 1*s*. gold. The 2*s*. ratio passed in 1920, remained on the statute-book, and was ineffective for purposes of tender of gold to the currency office."[1]

After some time exchange recovered and began to move upwards and reached 1*s*. 4*d*. gold in October 1924. From this time onwards it continued rising, and was prevented from rising above 1*s*. 6*d*. by free purchases of sterling on the part of the Government.

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[1] *Hilton Young Commission Report*, p. 4.

CHAPTER XXXIV

HISTORY OF INDIAN CURRENCY

(1925–1946)

Hilton Young Commission

IN August 1925 a Royal Commission on Indian Currency and Finance, under the chairmanship of Edward Hilton Young was appointed to investigate into and suggest improvements in the Indian currency and finance problems.

Defects of the System

The Commission first analysed the then existing state of affairs and pointed out its defects.

Not Simple and Intelligible

The first defect of the system which they point out is that it is not simple and that the basis of the stability of the rupee is not intelligible to the uninstructed public. "The currency consists of two tokens in circulation, with the unnecessary excrecence of a third full-value coin which does not circulate at all. One form of token currency (into which there is an unlimited obligation to convert the other) is highly expensive, and is liable to vanish if the price of silver rises above a certain level." The value of the currency is maintained at 1*s.* 6*d.* by the Government's free purchase of sterling at 1*s.* $6\frac{3}{16}$ *d.* This stability is at present based on the policy of the Government; there is no legal obligation to do so.

Two Reserves

There are held two reserves, the gold standard reserve and the paper currency reserve, for the purpose of maintaining the value of the Rupee. Though, in fact, the two reserves had different functions originally, there is at present no demarcation between the purposes for which they are used. In principle these reserves in order to be efficient should be big enough and should be used promptly and without condition. But "in the Indian system these principles have not at all times been clearly recognized and they are not now and never have been adequately supported and enforced by statutory provisions".

Dual Control

At present currency and credit in India are controlled by two authorities, the Government of India and the Imperial Bank respectively. This means a dual control and a division of responsibility in the control of credit and currency policy. And besides this the banking and currency reserves of the country are separated and are consequently less capable to effect their specific purpose of stabilisation in the most economical and efficient manner.

No Provision for the Automatic Working of the Exchange Standard

The greatest defect of the system is that there has not been any provision for an automatic working of the exchange standard. "The fundamental basis of such a standard is provision for the expansion and contraction of the volume of currency. As the reserve rises or falls with a favourable or an adverse balance of trade, the currency must be automatically expanded or contracted, and the adjustment between internal and world prices maintained. Under the Indian system, contraction is not, and never has been, automatic. On occasions the obligation to buy sterling exchange has been discharged by the Government without any corresponding expansion of domestic currency: the purchases have in the first instance been made against Treasury balances and the currency expansion has been left to be effected subsequently at the discretion of the Government."

Inelastic

And lastly, the Commission point out that, the system is inelastic. The volume of Indian currency does not vary freely in response to the varying requirements of trade; nor is there any provision for the expansion of currency at times of great financial crisis.

The Commission think that on account of the above defects the system has not the confidence of the people. And they think that a system which is simple and in which people will have confidence should be adopted in India.

Rejected Exchange Standard

The Commission, therefore, rejected the idea of an exchange standard, as they considered it to be defective and not simple. They rejected a sterling exchange standard for the reasons that if the price of silver rises above a certain limit the silver currency will be threatened; if sterling were to be divorced from gold, the rupee would also be divorced;

and if sterling were to depreciate, Indian prices would have to follow sterling prices, and the rate of exchange would have to be raised. In the case of a gold exchange standard also the rupee will vanish if the price of silver rose above the melting point. Besides this an exchange standard not being simple will not possess the confidence of the public. An exchange standard and the basic right of convertibility under it are too abstract and cannot be understood by people without some knowledge of economics. A system which is not easily intelligible cannot possess the confidence of the people, and under it the habits of banking and investment will consequently be delayed.

Recommendations—Gold Bullion Standard

The Commission, for these reasons, recommended a gold standard (Gold Bullion Standard) and thought that Gold Standard under which the currency of the country will be convertible into gold both for internal and external purposes will suit India most. "In the present state of its development Indian public opinion will have confidence in one thing only as solid enough for a backing for its currency, and that is gold. It requires some link that is real, and not only real but conspicuously visible, between the currency of the country and gold."

The Commission, however, do not recommend a gold standard with a gold currency, but instead, a gold standard without a gold currency or as they call it a 'Gold Bullion Standard'. And they consider this even better than a gold standard with a gold currency, for they point out that both are equally certain and stable while over and above this a Gold Bullion Standard is cheaper and more efficient. "If the gold in the reserve is transferred to the circulation, the structure of credit that can be built on that reserve is *protanto* reduced. The greater the proportion of gold in circulation, the less the elasticity of the currency system."

The essentials of the Gold Bullion Standard, they point out, are that the ordinary medium of circulation in India should be the currency note and the silver rupee, and these should be convertible into gold at a fixed rate for any purpose whatsoever. To ensure this there should be an obligation imposed by law on the currency authority to buy and sell gold without limit at fixed rates, but in quantities not less than 400 fine ounces.

Since gold is not to circulate the sovereign should cease to be legal tender.

Notes to be Convertible into Gold

That new notes are to be issued and these should be made convertible into gold and not into rupees. Since both rupees and notes are tokens there is not much meaning in the one being convertible into the other. And the removal of this obligation will free the currency system of the country from the dangers of the fluctuations in the price of silver.

Amalgamation of Reserves

That the two reserves—the paper currency reserve and the gold standard reserve—should be amalgamated and the proportions and composition of the combined reserve should be fixed by law. And, they recommend that gold and gold securities should form not less than 40 per cent. of the total reserve.

Creation of a Central Bank

The second recommendation of the Commission is for the creation of a Central Bank for India, with the sole right of note issue and the responsibility of maintaining the stability of the currency. For this purpose a new central bank (Reserve Bank) should be created under a new charter and should be entrusted the currency functions and should be the custodian of currency and banking reserves and the cash balances of the Government.

The third recommendation of the Commission is with regard to the ratio of the stabilisation of the rupee. The Commission recommend that the rate of exchange should be fixed at 1*s.* 6*d.* gold. They point out that for the last one year or so the rate has been at 1*s.* 6*d.*, therefore, any change from that ratio will affect prices and consequently affect the people adversely.

Action Taken

The Government incorporated the recommendations of the Commission in two Bills, (1) a bill to establish gold standard currency for British India and constitute the Reserve Bank of India, and (2) a bill for the adoption of the Ratio.

The first bill, as has been mentioned in the chapter on a Central Bank, was postponed *sine die*. The other bill was passed by the Assembly with one or two minor amendments and by the Council of State, and became law and came into operation from 1st April 1927. Subsequently, however, the Government also linked the rupee to gold, by taking upon itself the obligation to buy and sell gold for rupees to an unlimited extent at a fixed rate.

According to the new Act the 1*s.* 6*d.* ratio was established and the sovereigns and half-sovereigns ceased to be legal tender in India. An obligation was however imposed upon the Government to receive them at all currency offices and treasuries at their bullion value, *i.e.*, at Rs. 21–3–10 per tola of fine gold or Rs. 13-3-10 per sovereign.

England went off Gold Standard

On September 21, 1931, England went off the gold standard and suspended gold payments. On the same date the Government of India issued an ordinance, suspending the appropriate sections of the Currency Act of 1927 and thus withdrawing the obligation to sell gold or sterling. This made the rupee free for formerly it was linked to gold through sterling as sterling was equal to gold. The divorce of the rupee from sterling was welcomed by Indian public opinion as it meant that the ruinous exchange policy followed by the Government since 1927 had been given up and that the rupee would find its own level and the ratio of exchange will fall. But the Secretary of State made a different announcement in the Federal Structure Sub-Committee and linked the rupee to sterling. This was different from the action already taken by the Finance Member and it created a very peculiar situation under which the banks had to carry on their business in a state of uncertainty. In the face of this the Government declared the three succeeding days as bank holidays under the Negotiable Instruments Act.

Indian Currency System at the Present Day

Finally, Ordinance VII, with the following provisions, was promulgated on the 25th of September 1931 :—

(1) That the rupee was linked to sterling at 1*s.* 6*d.* and the Government was thus under the obligation to sell sterling at 1*s.* 6*d.*

(2) That sterling was to be sold for genuine trade purposes and for reasonable domestic purposes.

(3) That the sales of sterling were to be through the Imperial Bank at its branches at Calcutta and Bombay to certain recognized banks.

Public opinion in India very much resented this action of the Secretary of State for it was thought that the linking of the rupee to the sterling would make the value of the rupee as unstable as that of the sterling, and that the rupee would depreciate with the depreciation of the sterling. Besides this it would deplete the gold resources of the country.

And since September 1931 upto August 1933 actually £120 million worth of gold was exported from this country, and it has continued to the present day.

Reserve Bank

In 1934 the Reserve Bank Act for the starting of a Central Bank in India was passed on March 6, in the same year it received the assent of the Governor-General-in Council. Subsequently the Reserve Bank of India was constituted with a view "to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in British India and generally to operate the currency and credit system of the country to its advantage". But even with the creation of the Reserve Bank the question of monetary standard for India was left where it was. It was thought expedient, as the preamble of the Reserve Bank Act points out, "to leave the question of the monetary standard best suited to India to be considered when the international monetary position has become sufficiently clear and stable to make it possible to frame permanent measures".

Existing Monetary Standard of India

According to the Reserve Bank of India Act, the ratio of exchange is to be maintained at 1*s*. 6*d*. sterling. The Reserve Bank is required to sell sterling at 1*s*. $5\frac{49}{64}$ *d*. per rupee and to buy sterling for immediate delivery in London at 1*s*. $6\frac{3}{16}$*d*. per rupee. Thus according to this provision the value of the rupee cannot fall below 1*s*. $5\frac{49}{64}$*d*. and rise above 1*s*. $6\frac{3}{16}$*d*. The rupee has been statutorily linked to sterling and a Sterling Exchange Standard has been established in India. The two currency reserves have been abolished and the Reserve Bank has assumed the control of currency and credit.

The World War II and Indian Currency and Exchange

Immediately after the outbreak of the war and particularly after the fall of France in 1940, people in this country became panicky and there was a sudden and great demand for rupee coins in exchange for notes. At first this demand was met by the Reserve Bank, which resulted in a decline of the rupee reserve from Rs. 85 crores in September 1939 to Rs. 35·1 crores on 21st June 1942. In June 1940, however, an ordinance was passed which made it illegal for any person to acquire more rupee coins than his personal or business requirements. In July 1940, with a view to meeting the demand for conversion of notes into rupees, one rupee notes were put into circulation, and the refusal to accept notes was made an offence under the Defence of India Rules.

At the same time Government reduced the silver contents of the half and quarter rupees and issued new rupees with reduced silver contents. This was necessitated by the increase in demand for rupee coins on account of increased trade activities, absorption of rupees in hoards and the unsuitability of rupee notes for some rural areas.

While the problem of the hoarding of the rupee coins was being met by the above measures another problem that of an acute shortage of small coins arose in 1942 all over the country. In the first two and a half years of the war small coins to the value of Rupees eight crores were absorbed and in 1942 absorption of these further increased. To meet this situation the possession of small coin in excess of one's genuine and personal requirements was made on offence. Selling and buying of small coins at higher than their face value was prohibited under D.I.R. A new half anna nickel-brass coin was issued and a new pice weighing only 30 grains instead of 75 was minted. This pice, however, soon went out of circulation as people used it as a washer.

But the most notable effect of war on Indian currency has been the enormous expansion of Indian currency since 1939. On 1st September 1939, notes to the value of Rs. 172·37 crores were in active circulation, while on 26th January 1945 their amount was Rs. 937 crores. They had increased by over 500 per cent. The enormous expansion in Indian currency has been secured by almost an equal expansion of sterling securities which form the biggest single asset of the Issue Department of the Reserve Bank. The amount of sterling securities held by the Reserve Bank was Rs.59 crores on 1st September 1939. On 26th January 1945 their amount was Rs. 929·2 crores—an increase of 1450 per cent. The volume of rupee securities increased from Rs. 37 crores to Rs. 50 crores—57 per cent. Gold coin and bullion has remained stationary but silver coin has declined from Rs. 67 crores to Rs. 13 crores.

This huge expansion of Indian currency has naturally led to a great rise in the price level of the country. This has been more so as there has not been any appreciable corresponding increase in the volume of production. Even the official index number recorded a rise of 349 per cent. in the price-level, though it does not take into account black-market prices which were a normal feature in Indian markets during war and which were very much higher than official figures. In the United Kingdom and U.S.A. during almost the same period the rise in price-level was only 71 per cent. and 37 per cent. respectively.

Inflation in India

The great rise in prices in India is not entirely due to expansion of currency. Many other causes also contributed to it, for example, inadequate transport facilities; restrictions on movement of goods between provinces and different parts of the country, creating difficulties of distribution between producing and consuming areas; practical stoppage of imports in the face of increased demand for goods and not much expansion of production in spite of favourable conditions for the same. The growing scarcity of goods for civilian use, the increased money supply and the diversion of resources to war services have all contributed to the rapid and general upward movement of prices.

But the most important and the greatest reason for inflation has been the rising budgetary expenditure the Government of India incurred on its own behalf and on behalf of the Allies. Whereas the Government of India provided the entire rupee finance for financing war expenditure in India, the British Government have discharged their obligation towards war expenditure in India by providing sterling in London. The bulk of the sterling has remained blocked up in London while notes have been issued in India against it; so that the Government of India has been resorting to inflation for financing war expenditure in India for which the British Government were responsible. If the British Government would have provided the necessary finance the Government of India would not have taken recourse to inflation. In other words, if India had been free or if it had a national government it would not have been compelled to inflate its currency and rob its own people and cause the distress which **inflation did actually cause.**

Evils of Inflation

The worst evils of inflation were due to the apathy of the Government towards expansion of production. The war, which made imports almost impossible and provided a natural state of protection for Indian industries, was not taken advantage of and nothing was done to develop Indian productive resources. Inflation, which raised prices, further provided strong stimulus to economic development, but an alien government deliberately curbed indigenous enterprise and did not allow any real expansion of production. Inflation thus proved an unmitigated evil and caused untold misery and distress to the bulk of the population of the country. Except for a handful of men, the war profiteers who waxed rich and overnight became millionaires, the rest of the population suffered. It created a new rich class, which grown rich suddenly and without any special effort or talent, lived extravagantly and spent recklessly. It increased speculation and gambling and introduced corruption in public services, administration and business practices as never before.

India is proverbially a poor country. This does not mean that India has not rich men. In fact compared with the poverty of the poor the riches of the few rich are out of all proportion. In no country the difference, in the possessions of the poor on the one hand and of the rich on the other, is so great as in this country. Inflation and war profiteering and corruption has made this difference even greater. Inflation has made the poor poorer, and the poor in this country form almost ninety per cent. of the population. To these poor the steep rise in the cost of living, officially estimated at 250 per cent., has caused untold privation, starvation, malnutrition and distress. The Bengal Famine of 1943, according to the estimates of the Famine Commission, cost 15 lakhs human lives besides the hardship and privation to a much larger number. If not entirely it was in some respects the outcome of inflation. A rise in wages by about 50 per cent. and dearness allowances of 10 to 17½ per cent. could hardly give any relief to the poor who were already living on the margin of subsistence. Immediately on the termination of the war, workers and employees of almost all classes clamoured for and demanded higher wages. There were and are threats of strikes and actual strikes unprecedented in the history of this country. Previously one heard now and then of strikes of factory labour, now besides factory labour, railway workers, postal staff, ministerial staff, school masters, scavengers, policemen, etc., etc., all are threatening or going on strikes. With so many strikes and so much dissatisfaction among the workers, there has creeped in looseness in work and administration and corruption. The energy of the Governments is being frittered away in dealing with these problems rather than in taking up reconstruction programmes.

Anti-Inflationary Measures

The complacency of the Government can be judged from the fact that until 1943-44 it refused to recognize the existence of inflation in India. It was in the budget speech of 1944-45 that the Finance Member for the first time took notice of inflation and regarded it necessary to deal with the menace. But even then further issue of currency was not stopped, in fact currency continued to be inflated until the end of the war. The Government did however do some scratching of the surface and the following anti-inflationary measures were adopted:—(1) Taxes were increased and whenever possible taxes were collected in advance. (2) Ceiling prices of a number of commodities were fixed. (3) Forward trading in bullion, cotton and share markets was prohibited. (4) Partial rationing was introduced. (5) Arrangements were made for larger supplies and better distribution of consumer's goods. The object of these measures was to arrest the upward trend of prices. Besides these an ordinance—Hoarding and Profiteering Prevention Ordinance—was passed in October 1943, with a view to controlling prices. The ordinance did not produce any effect and proved a failure. Even other measures, pointed out above, proved only partially effective. Upward trend of prices was checked only partially and black-marketing and profiteering continued almost unabated.

Sterling Balances

If on the one hand there has been enormous inflation of currency in India, on the other, as against it, there has been accumulation of large sterling resources, held by the Reserve Bank as backing against the note issue. All countries belonging to the sterling area—Egypt, Canada, New Zealand, Australia, Eire, India and even Argentine—have accumulated sterling resources as against the purchases in these countries by the British Government. But it is only in the case of India that the accumulation has been so great. India, before the war, was a debtor country. The total sterling debt of India at the end of 1936-37 was £356 million or Rs. 475 crores; in October 1945 India held sterling resources of the value of Rs. 1,500 crores for disposal. It has become a creditor country to this extent after having paid off its sterling debts in London—after clearing off its old debts.

The sterling balances have accumulated as a result of the war purchases in India by the British Government, also as a result of the purchases in India by the United Nations for which payment is made in sterling in London. According to the provisions of the Reserve Bank Act, the Reserve Bank is under obligation of converting sterling offered in London into rupees in India. Thus the sterling accumulations are responsible for the enormous increase of notes issued by the Reserve Bank, or for the enormous inflation. This inflation as we have seen has caused untold suffering to the bulk of the people in this country ; the sterling balances have thus been purchased at a huge cost in terms of human suffering.

The sterling balances held by the Reserve Bank form the main backing for the inflated currency of India. They are assets of the Reserve Bank already in its possession. In this respect they are not really Britain's war debts to India ; they are not debts which have to be realized, but are assets which are already in possession. They are debts, however, in the sense that they at present represent blocked sterling. Except to a very limited extent, we cannot use them at present to purchase whatever goods we like from the United Kingdom or other countries, because of the existence of exchange control and export trade regulations in Britain.

It is in the interest of India to be able to utilize the sterling balances in buying capital goods, in the cheapest markets abroad and as quickly as possible, for its post-war reconstruction programme. Indian public opinion naturally feels that the sacrifice and hardship that the country has undergone during war should not continue longer and its efforts towards economic development and the reconstruction of its economy should not be thwarted or delayed. Indian public opinion also resents any suggestion for the scaling down of the sterling balances. It argues that the sterling balances are the result of Britain's war expenses—a war which was not of India's making and in which India had no say. That these balances were purchased at a huge cost of suffering and privation to the people and that the purchases made by Britain in India were made at control prices and England therefore had to pay actually less for commodities in this country than the people of the country were paying at black-market rates.

A part of the sterling resources have already been utilized for wiping out India's sterling debts and for capitalization of sterling pensions, family pensions and provident funds. It is suggested by some that these balances can be very profitably utilized in buying off British investments in India. The suggestion is both impracticable and unwise. Firstly long-established British firms will not be prepared to liquidate themselves and secondly the present is not the proper time to buy them off as due to war profiteering the capitalized prices of such foreign investments have become greatly increased.

The liquidation of sterling resources would however raise two problems which must be kept in view. Firstly, the problem of deflation, since sterling balances are at present the chief backing against the present volume of paper currency in India, their liquidation is bound to lead to deflation unless some other backing were provided against the note issue. And secondly the sterling balances being the assets of the Reserve Bank, it may not be prepared to part with them unless equivalent rupee price is paid for them. There is thus the problem of the rupee finance involved in any scheme of the disposal of the sterling balances.

However, it is evident that the liquidation of the sterling balances will be slow and gradual. The speed at which Britain will be able to repay them will depend on the post-war capacity of her export industries and her capacity to forego current consumption. In the immediate future there does not seem to be much prospect of any of these capacities to be considerable.

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